Supreme Court, U.S.
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No. 10- 10-682

IN THE
Supreme Court of the United States

RBC CAPITAL MARKETS, LLC
(F/K/A RBC CAPITAL MARKETS CORPORATION),

Petitioner,

v.

LEONARD SCHNEIDER, LESLIE SCHNEIDER,
SCOTT SCHNEIDER, SUSAN SCHNEIDER,
AND HIGHLAND CAPITAL MANAGEMENT, L.P.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. In overturning a jury's finding that there was a breach of a $35 million agreement for the sale of securities, did a Second Circuit panel violate the Reexamination Clause of the Seventh Amendment and this Court's precedents where it abandoned the traditional circuit test for reviewing the sufficiency of evidence and instead adopted a new standard under which it weighed the meaning and importance of the evidence and drew inferences in favor of the moving party?

2. Did the Second Circuit violate this Court's precedents by failing to give any deference to the trial court's determination that there was sufficient evidence to support the jury's verdict?

PARTIES TO THE PROCEEDINGS BELOW AND RULE 29.6 DISCLOSURE STATEMENT

Petitioner RBC Capital Markets, LLC (f/k/a RBC Capital Markets Corporation) ("RBC" or "Petitioner") is a private non-governmental party and is an indirect, wholly-owned subsidiary of the Royal Bank of Canada, which is a publicly-traded company.

Nominal Respondent Highland Capital Management, L.P. ("Highland") is a private non-governmental party with no parent corporation, and there is no publicly-held company that owns more than ten percent of Highland. RBC and Highland were treated as co-plaintiffs at trial in the United States District Court for the Southern District of New York and were appellees in the United States Court of Appeals for the Second Circuit.

The Respondents to this petition are Leonard Schneider, Leslie Schneider, Scott Schneider and Susan Schneider (together, the "Schneiders"). The Schneiders were defendants in the United States District Court for the Southern District of New York and appellants in the United States Court of Appeals for the Second Circuit.

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PETITION FOR WRIT OF CERTIORARI

Petitioner RBC respectfully petitions for a writ of certiorari to review a judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

In all, a total of fifteen opinions have been issued in this case. The decision of the United States Court of Appeals for the Second Circuit is reported at 607 F.3d 322 (June 11, 2010) (June 22, 2010, Errata Filed). (Pet. App. 1a-20a.) This decision reversed an unpublished decision issued on August 20, 2008 by the United States District Court for the Southern District of New York that denied the Schneiders' motion for judgment as a matter of law or, in the alternative, for a new trial, which is electronically available at No. 02 Civ. 8098, 2008 U.S. Dist. LEXIS 63874 (S.D.N.Y. Aug. 20, 2008). (Pet. App. 21a-58a.)

Petitioner RBC's timely petition for panel rehearing and rehearing *en banc* was denied by the Court of Appeals on August 23, 2010. (Pet. App. 59a-60a.)[1]

The United States District Court for the Southern District of New York initially addressed the parties'

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1. Plaintiff-Appellee and nominal Respondent Highland also timely filed a petition for rehearing *en banc*, which was denied by the Court of Appeals on July 29, 2010. Highland's petition for writ of certiorari was submitted on October 27, 2010 and docketed on November 4, 2010 as *Highland Capital Management, L.P. v. Leonard Schneider, et al.* (No. 10-591) (the "Highland Petition").

summary judgment motions in an unpublished opinion, which is electronically available at No. 02 Civ. 8098, 2005 U.S. Dist. LEXIS 14912 (S.D.N.Y. July 26, 2005). (Pet. App. 61a-119a.) Two other decisions of the Second Circuit addressing the summary judgment motions are reported at 198 Fed. Appx. 41 (2d Cir. 2006) and 485 F.3d 690 (2d Cir. 2007). The opinion of the United States District Court for the Southern District of New York addressing the summary judgment motions on remand is reported at 533 F. Supp. 2d 345 (S.D.N.Y. 2008).

Three decisions in this case addressed the question of whether the promissory notes at issue were securities for purposes of New York law and therefore outside the New York statute of frauds. The United States Court of Appeals for the Second Circuit certified the question in an opinion reported at 460 F.3d 308 (2d Cir. 2006). (Pet. App. 120a-152a.) The New York Court of Appeals accepted certification in an opinion reported at 7 N.Y.3d 836, 857 N.E.2d 527, 824 N.Y.S.2d 206 (N.Y. 2006) (Pet. App. 153a-154a), and found that the promissory notes were securities within the meaning of Section 8-102(a)(15) of the New York Uniform Commercial Code in an opinion reported at 8 N.Y.3d 406, 866 N.E.2d 1020, 834 N.Y.S.2d 692 (N.Y. 2007) (Pet. App. 155a-177a).

Certain other opinions issued in this case do not relate to the questions presented. These reported and unreported decisions can be found at No. 02 Civ. 01678-H, 2002 U.S. Dist. LEXIS 18207 (N.D. Tex. Sept, 27, 2002); No. 08 Civ. 8098, 2004 U.S. Dist. LEXIS 18131 (S.D.N.Y. Sept. 9, 2004); 379 F. Supp. 2d 461 (S.D.N.Y. 2005); No. 08 Civ. 8098, 2007 U.S. Dist. LEXIS 97453 (Sept. 28, 2007); and 551 F. Supp. 2d 173 (S.D.N.Y. 2008).

JURISDICTION

Petitioner RBC's timely petition for panel rehearing and rehearing *en banc* was denied on August 23, 2010. This Court has jurisdiction to review the decision of the United States Court of Appeals for the Second Circuit pursuant to 28 U.S.C. Section 1254(1).

CONSTITUTIONAL PROVISION INVOLVED

U.S. CONST. amend. VII. Civil Trials

> In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law.

STATEMENT OF THE CASE

This case presents important questions regarding the power of appellate courts to overturn jury verdicts with which they disagree and the extent to which appellate courts should defer to a trial court's first-hand experience in reviewing the sufficiency of the evidence. Here, a Second Circuit panel ruled that there was insufficient evidence to support a jury's findings by adopting a standard of review under which it drew inferences in favor of the moving party from supposedly "undisputed" facts, substituted its own views of the meaning and importance of the evidence, and disregarded substantial evidence that supported the verdict, all in the context of deciding issues that had

not even been raised on appeal. Tellingly, the opinion omitted any reference to *Reeves v. Sanderson Plumbing Products, Inc.*, 530 U.S. 133 (2000), or any other Supreme Court decision setting forth the appropriate standard for appellate review of a motion for judgment as a matter of law, the traditional standard of review applied by the Second Circuit in testing the sufficiency of the evidence, and the District Court's 46-page opinion denying the Rule 50 motion for judgment as a matter of law.

This case involves a disputed securities transaction. On March 14, 2001, after two months of extensive negotiations, the Schneiders, through their long-time securities broker, Glen Rauch ("Rauch"), orally agreed to sell to RBC eight subordinated promissory notes with a par or face value of $69 million at a discounted price of 51 cents on the dollar. RBC, which had lined up buyers to purchase the notes once it had acquired them from the Schneiders, advised its clients, Highland and Fidelity Management & Research Company ("Fidelity"), that an agreement on the essential terms had been reached, subject to documentation. The Schneiders subsequently refused to honor the transaction and denied there had been any agreement. In April 2001, an announcement was made that McNaughton Apparel Group, Inc. ("McNaughton"), the issuer of the notes, had entered into an agreement to be acquired. Payment under the terms of the notes was accelerated, and in June 2001, the Schneiders received $69 million in cash for the notes. Discovery in the case and testimony at trial established that the Schneiders had non-public information regarding discussions in which McNaughton was engaged at the time they reneged on the trade. As

a result of the failed transaction, RBC's two largest customers on its high-yield bond trading desk ceased doing business with RBC. This lawsuit followed.

Procedural History

The complex procedural history of this action, ignored by the panel, highlights the careful attention paid to the issues by the trial judge and his familiarity with the record. This action was initially filed in Texas state court in 2001, subsequently removed to the federal court on diversity grounds and transferred to the Southern District of New York, where it was assigned to Judge Peter Leisure. In July 2005, following the close of discovery, the District Court granted the Schneiders' motion for summary judgment dismissing Highland's claims and declined to exercise supplemental jurisdiction over the third-party claims and counterclaims involving RBC. (Pet. App. 61a-119a.) In his opinion, the district judge carefully reviewed the evidence in the record, including transcripts of audiotaped conversations during the two months of negotiations and affidavits by the individuals involved in the key events, and concluded that there were triable issues of fact as to whether an oral agreement on the essential terms for the sale of the notes had been reached on March 14, 2001 and whether Rauch had authority to bind the Schneiders. (*Id.*) The District Court observed that a trial of those issues would present a classic credibility test for the jury: "if a jury finds Highland and RBC's witnesses more credible than defendants, a jury could also find that these were the terms of the agreement." (*Id.* at 90a-91a.)

Although the District Court concluded there were triable issues of fact, it nonetheless dismissed Highland's third-party beneficiary claim on jurisdictional grounds because it determined that the promissory notes at issue were not securities under New York law (which are exempt from the New York Statute of Frauds) and that enforcement of the alleged oral agreement between RBC and the Schneiders for an amount in excess of $5,000 was therefore barred. (*Id.* at 117a-119a.)

On appeal, a panel of the Second Circuit affirmed the dismissal of certain counts, but certified to the New York Court of Appeals the question of whether the promissory notes were securities under New York law. (Pet. App. 120a-152a.) The New York Court of Appeals agreed to resolve the issue and subsequently ruled that the promissory notes were securities under the New York Uniform Commercial Code. (Pet. App. 153a-154a, 155a-177a.) In light of that decision, the Second Circuit reversed the judgment dismissing Highland's third-party beneficiary claim, specifically noting that the District Court in its earlier opinion had identified triable issues of fact regarding Rauch's authority and whether an oral agreement had been reached with RBC. 485 F.3d at 692-93.

Following remand, the District Court exercised supplemental jurisdiction over the claims involving RBC, and the case proceeded to trial in February 2008 on RBC's contract claims and Highland's third-party beneficiary claim. During a three-week trial, 22 witnesses testified and over 100 exhibits were admitted into evidence, including audiotapes of numerous conversations. The witnesses included former RBC and

Highland employees who had been involved in the transaction, as well as Glen Rauch and each of the Schneiders, and the testimony covered the key events and conversations, as well as custom and practice in the securities industry. RBC offered the testimony of three former employees regarding the pivotal telephone conversation on March 14, 2001 in which Rauch confirmed the transaction. The Schneiders denied that Rauch was authorized to sell the notes and denied that there had been an agreement to do so. During the trial, the Schneiders and Rauch were impeached repeatedly on the issues of Rauch's authority and the existence of an agreement. (Pet. App. 26a, 32a.)

THE TRIAL

The evidence established that Leonard Schneider and his three adult children, Leslie, Susan and Scott, received approximately $216 million in a combination of cash, common stock and the notes from McNaughton for the sale of their apparel businesses. Shortly after learning in December 2000 that payments on the notes would be "minimal, at best," due to McNaughton's financial condition,[2] Leonard Schneider began selling his stock, and the Schneiders took steps to sell the notes. To assist them, they engaged Rauch, who had a long-term relationship as the family's broker for trades involving tens of millions of dollars in securities over the course of two decades.

Rauch contacted Ken Ambrecht, a senior salesperson on RBC's high-yield trading desk, about a

2. (Pl. Ex. 12, Tr. 657-58.)

possible sale of the notes. After a letter agreement was negotiated and signed between RBC and Rauch, RBC began marketing the notes to institutional clients of the high-yield group. RBC intended to act as a "riskless principal," purchasing the notes from the Schneiders only after it had identified a third-party end-purchaser. Rauch insisted that no prospective buyers of the notes contact McNaughton and that all inquiries related to the notes were to be directed to him. Further, Rauch informed RBC that the Schneiders' attorney had instructed that all communication between RBC and the Schneiders was to take place through Rauch.

Over the course of the next two months, discussions proceeded, and it became clear that any sale of the notes was going to be at a deeply discounted value given the questions about McNaughton's solvency. Although Leonard Schneider claimed at trial that he never authorized Rauch to make any offers to RBC, recorded conversations established that Rauch, on the Schneiders' behalf, made several "firm offers" – *i.e.*, binding, unconditional offers under securities industry custom and practice – for the sale of the notes and that, by early March 2001, Leonard Schneider was "anxious" to conclude a deal for the sale of the notes.[3]

The critical events took place during the week of March 12, 2001. During a recorded conversation on the morning of Monday, March 12, Ambrecht informed Rauch that he believed he could make a bid of 51 cents to purchase the notes. Rauch replied that he had

3. (Pl. Ex. 80, CD725:3.8.03, Tr. 255.)

spoken to the Schneiders over the weekend and earlier that morning, and made an offer at 51 cents:

Ambrecht:	If I came back with a firm fifty-one bid do you think the whole thing trades here?
Rauch:	Yup.
Ambrecht:	All sixty-nine million?
Rauch:	Yup.[4]

Evidence at trial revealed that this offer came after Leonard Schneider had already learned from the family's attorneys the preceding week that they had been advised by a senior officer of McNaughton that "something good was happening with the company" and that he should stop selling stock.[5]

After Ambrecht countered with a firm bid of 50.5 cents, Ambrecht and Rauch were back to discussing the 51 cent price on the afternoon of March 12. By that time, RBC had arranged for the two biggest customers on the high-yield desk, Highland and Fidelity, to purchase the notes. The deal was not completed on March 12, but Rauch believed an agreement was imminent, and he sent a letter to the Schneiders concerning his proposed compensation that day. (Pet. App. 26a.) The following day, Rauch told Ambrecht the family was meeting and "You know we're not haggling,

4. (Pl. Ex. 80, CD725:3.12.03, Tr. 261.)

5. (Tr. 837.)

we're done at fifty-one if it gets done and it will probably be tomorrow morning."[6]

On Tuesday, March 13, 2001, the family conferred further with their counsel about the information from McNaughton. According to the Schneiders, they speculated that the preliminary discussions might involve a takeover and that, if that were the case, the notes would be paid in full. It was undisputed that there had been no additional contact with senior officers of McNaughton since Friday, March 9, and the attorneys for the family did not testify at trial.

The Sale Of The Notes

On March 14, 2001, there were two recorded conversations followed by a multi-party call that did not take place on a trading desk and thus was not recorded. In the first conversation that morning, Ambrecht inquired about Rauch's communications with the Schneiders and was assured that the family had not changed their minds.[7]

In the second recorded conversation, Ambrecht questioned Rauch regarding the sale of the notes, and Rauch confirmed that a trade would involve all $69 million of the notes:

Ambrecht: And that's going to be for all the sixty-nine million?

Rauch: Yeah, that's for all of them, yeah.[8]

6. (Pl. Ex. 80, CD725:3.13.01-.02, Tr. 264.)

7. (Pl. Ex. 80, CD725:3.14.01-.02, Tr. 265.)

8. (Pl. Ex. 80, CD725:3.14.06-.10, Tr. 266.)

Rauch further indicated during this call that he would be speaking with the Schneiders' attorney for language to include in the confirmation of the trade and that he would not "go out on a limb" before speaking to the attorneys.[9] Ambrecht understood that an agreement to sell the notes had been reached on this second recorded call on March 14, 2001.[10]

Because of the importance of the transactions, including the fact that its two biggest customers were on the other side of the trade, RBC wanted to be absolutely sure there was a deal.[11] Thus, Ambrecht, as well as the two Co-Heads of the high yield group, Peter Parent and Max Holmes, had another conversation that afternoon with Rauch from Holmes' office. Parent explained that he participated in the call to make sure "that every I was dotted and T was crossed."[12] Parent, who had 24 years of experience in the business, further testified that Rauch confirmed that an oral agreement had been reached on that call:

> Q. And tell me everything you remember about that conference call.

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9. (*Id.*)

10. (Tr. 266-67.) RBC's expert also testified that based on industry custom and practice the contents of the recorded conversations indicated to him that an oral agreement to sell the notes "as-is" had been reached on the taped calls. (Tr. 621.)

11. As Parent explained at trial, "[i]t would be career suicide to confirm a trade of that magnitude without knowing that you had a trade." (Tr. 163-64.)

12. (Tr. 150-51.)

A. I remember where I was sitting in the office. I remember where Kenny was sitting, where Max was sitting, and that Glen confirmed size and price with us, 69 million at 51, which means that we had a transaction.

Q. Was anything else said on the call?

A. Glen was going to get the lawyers to send us a confirm so that we could go to a written form of contract.

. . . . . .

Q. What was your understanding at the end of that phone call, Mr. Parent?

A. That we were done on the trade, that we could buy the securities at 51.[13]

Following the conversation with Rauch, Parent reported to his supervisor in Toronto that "we just traded the Nortons" on a taped call[14] and confirmed the transaction to Fidelity, his biggest client.[15] RBC also confirmed the trade with Highland and engaged attorneys to close the trade.

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13. (Tr. 151.)

14. (Pl. Ex. 79, CD894:3.14.05, Tr. 155-56.)

15. (Pl. Ex. 79, CD 894:3.14.04, Tr. 153.)

Rauch offered a diametrically different version of that call. According to Rauch:

> [Holmes] said, Glen, where are we on the transaction? I said, What do you mean? He said, Do we have size and price? I said, No, we don't have size and we don't have price. He said, Then you mean we're nowhere? I said, Yeah, unfortunately that's where we are. He said, OK, that's it, good-bye. And that was it.[16]

The Schneiders Renege On The Trade

The next day, Thursday, March 15, Rauch reported to RBC that the attorney was reviewing all the documents.[17] It was not until March 20, 2001, the third business day after the trade, that Rauch told RBC that the Schneiders had changed their minds about selling the notes and falsely told RBC that the Schneiders wanted to sell a large block of McNaughton stock instead.[18] Leonard Schneider acknowledged at trial that Rauch's statements regarding the stock sales were not truthful: "Q: So your family representative was lying to RBC in this exchange, isn't that right? A: Let's not call it lying. But he was not telling the truth."[19]

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16. (Tr. 539.)

17. (Pl. Ex. 80, CD725:3.15.04, Tr. 271.)

18. (Pl. Ex. 80, CD725:3.20.02, 3.20.02A-V, Tr. 273.)

19. (Tr. 842.)

The District Court's Denial of the Schneiders' Rule 50 Motion

The jury returned a unanimous verdict for RBC and Highland and awarded RBC in excess of $17 million in damages for breach of contract, including $5 million for lost business, and awarded Highland in excess of $22 million in damages as a third-party beneficiary. Following the jury verdict, the Schneiders moved for judgment as a matter of law under Rule 50(b) or, in the alternative, for a new trial under Rule 59. After extensive briefing, the District Court applied the prevailing Second Circuit standard of review and issued a thorough opinion denying the motions in all respects. (Pet. App. 21a-58a.) In denying the Schneiders' motion for judgment as a matter of law, the district court identified the following evidence, in addition to plaintiff's testimony regarding the March 14, 2001 untaped call, that supported plaintiffs' position that a binding agreement had been reached on March 14, 2001 and that Rauch was authorized to enter into the agreement:

1. "Plaintiffs presented ... evidence regarding RBC's actions following the agreement and Rauch's letter to Leonard [Schneider] regarding payment of a fee for his work on the transaction." (*Id.* at 26a.)

2. "[T]he Letter Agreement did not exclude Rauch from having the authority to bind defendants." (*Id.* at 31a-32a.)

3. "[I]t was industry custom and practice for brokers, like Rauch, to routinely enter into

binding agreements on behalf of their clients." (*Id.* at 32a.)

4. "Rauch, who was the family's broker for a number of years, [had] considered bids, including 'firm' offers, for the [n]otes on behalf of defendants in dealing with RBC." (*Id.*)

5. "[T]here was evidence that defendants directed that RBC communicate with defendants only through Rauch." (*Id.*)

6. "Testimony from defendants and Rauch indicated that Rauch routinely communicated with Leonard [Schneider] regarding trades for [his children] Leslie, Susan, and Scott [Schneider]" (*Id.*)

7. "Regarding the Letter Agreement, Rauch stated that Leonard [Schneider] authorized him to sign on behalf of Leonard, Leslie, Susan, and Scott." (*Id.*)

8. "Rauch also stated that Leonard [Schneider] 'usually spoke for his children.'" (*Id.*)

9. "[A]ttorney James Alterbaum represented all defendants and approved the Letter Agreement." (*Id.*)

10. "[P]laintiffs introduced Leonard's deposition testimony to impeach his testimony at trial on this issue." (*Id.*)

> 11. "Despite defendants' testimony in support of their position, their credibility was challenged more than once during the course of the trial. Such challenges included impeachment through the introduction of prior deposition testimony, as well as contradictory evidence presented by plaintiffs." (*Id.* at 26a.)

After denial of the Schneiders' motion, judgment was entered by the District Court in favor of the plaintiffs on August 20, 2008 in the amount of $64,492,617.95.

THE SECOND CIRCUIT APPEAL

The Schneiders timely appealed the judgment to the United States Court of Appeals for the Second Circuit. In their brief, the Schneiders identified a number of alleged legal errors but did not argue that the evidence presented at trial was insufficient to support the jury's verdict.[20]

In an opinion written by Judge Leval, the panel reversed the District Court's denial of the Schneiders' Rule 50(b) motion, holding that "[a] jury could not reasonably conclude, by a preponderance of the evidence, that RBC relied on Rauch's apparent authority to make the deal," making a *sua sponte* finding that there was insufficient evidence of an oral agreement to sell the notes by Rauch, and directing the District Court to dismiss the case in its entirety. (Pet.

20. At oral argument, certain members of the panel recognized that the Schneiders had failed to address the sufficiency of the evidence in their appellate papers and questioned whether such argument had been waived.

App. 20a.) In its opinion, the panel did not cite to this Court's decision in *Reeves* or even set forth the usual standard in the Second Circuit for review of jury awards.[21] Nor, for that matter, did the panel discuss any of the District Court's conclusions.

Instead, the panel created a new standard for Rule 50 review – *i.e.*, "we may not disregard undisputed evidence that bears on the interpretation of ambiguous matters." (Pet. App. 17a.)[22] The "undisputed" evidence,

21. *See, e.g., Gronowski v. Spencer*, 424 F.3d 285, 291-92 (2d Cir. 2005) ("'We will overturn a verdict only if there is 'such a complete absence of evidence supporting the verdict that the jury's findings could only have been the result of sheer surmise and conjecture, or such an overwhelming amount of evidence in favor of the [appellant] that reasonable and fair minded men could not arrive at a verdict against [the appellant].'") (quoting *LeBlanc-Sternberg v. Fletcher*, 67 F.3d 412, 429 (2d Cir. 1995)).

22. For justification, the panel cited to *Tomassi v. Insignia Fin. Group, Inc.*, 478 F.3d 111, 115-17 (2d Cir. 2007), but *Tomassi* simply holds that the court should consider all the evidence in the light most favorable to the plaintiff, which the panel plainly did not do. *Id.* (vacating district court's decision granting summary judgment and dismissing claims where evidence was sufficient to state a claim for employment discrimination). The standard of appellate review of a district court's denial of a Rule 50 motion is consistent across circuits, echoes the standard in *Reeves*, 530 U.S. at 150-51, and in no way resembles the standard articulated by Judge Leval in this case (Pet. App. 17a). *See, e.g., White v. N.H. Dep't of Corr.*, 221 F.3d 254, 259 (1st Cir. 2000); *Gronowski*, 424 F.3d at 291-92 (2d Cir. 2005); *Marra v. Phila. Hous. Auth.*, 497 F.3d 286, 300 (3d Cir. 2007); *King v. McMillan*, 594 F.3d 301, 312 (4th Cir. 2010); *Meaux Surface Prot., Inc. v. Fogleman*, 607 F.3d 161, 169 (5th Cir. 2010); *Imwalle v. Reliance Med. Prods., Inc.*, 515 F.3d 531, 543 (6th Cir. (Cont'd)

according to the panel, consisted of the recorded calls on March 14 and the self-serving testimony of the Schneiders about the material non-public information they had received. The panel did not simply consider that evidence, it went on to draw inferences from the supposedly "undisputed" evidence in support of the moving parties to conclude that the verdict should be overturned. (Pet. App. 17a-19a.) In effect, the panel accepted the very arguments advanced by the Schneiders that the jury had clearly rejected.

As explained below, the decision flatly violated long-standing Supreme Court precedent that prohibits an appellate court from drawing inferences from undisputed facts. With regard to Parent's testimony that Rauch had confirmed the essential terms of the transaction and said that he would get the lawyers to send RBC a written confirm the next day — testimony which plainly satisfies the "sheer surmise and conjecture" standard traditionally applied in the Second Circuit — the panel conceded that "such a statement by a broker" in Rauch's position could perhaps

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(Cont'd)

2008); *Von Der Ruhr v. Immtech Int'l, Inc.*, 570 F.3d 858, 866 (7th Cir. 2009); *Structural Polymer Group, Ltd. v. Zoltek Corp.*, 543 F.3d 987, 991 (8th Cir. 2008); *Josephs v. Pac. Bell*, 443 F.3d 1050, 1062 (9th Cir. 2006); *M.D. Mark, Inc. v. Kerr-McGee Corp.*, 565 F.3d 753, 761 (10th Cir. 2009); *Millennium Partners, L.P. v. Colmar Storage, LLC*, 494 F.3d 1293, 1299-1300 (11th Cir. 2007). *See also* 9B CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2524 (3d ed. 2008) (observing that although the different circuits use differing language to describe the standard, "It is doubtful... that those judicial utterances actually reflect different standards...").

reasonably have been understood by RBC as implying that he had received authorization for the contract and they had a deal but nonetheless found that testimony insufficient given the other "undisputed" evidence of the communications between RBC and Rauch. (Pet. App. 17a-18a.)

Notably, the panel did not consider at all the undisputed fact that RBC's actions following the call, in contacting its customers and lining up counsel, were consistent with the testimony of its former employees and totally at odds with that of Rauch and the Schneiders. Nowhere in the opinion does the panel attempt to explain why, if Rauch had in fact confirmed "we're nowhere" during the final call on the afternoon of March 14th, as he claimed at trial, RBC would have committed "career suicide," in Parent's words, by confirming the trade with its best customers.

REASONS FOR GRANTING THE PETITION

I. The Court Should Grant Certiorari To Provide Needed Guidance To Federal Appellate Courts Regarding The Limits Of Their Constitutional Power In Reviewing Jury Verdicts And The Importance of Following Supreme Court Precedents

The Reexamination Clause of the Seventh Amendment guarantees that "no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law." U.S. CONST. amend. VII. The Reexamination Clause is an express limitation on the

nature of appellate review and, as such, is the only provision in the Constitution that directly limits the power of appellate courts. Unlike other provisions in the Bill of Rights that intermediate appellate courts are fully capable of enforcing, only this Court is in a position to review whether the Reexamination Clause has been violated. Given the usurpation of the jury's role by the panel below, Petitioner respectfully suggests that this case presents an appropriate vehicle to prevent encroachment by the appellate courts upon the jury's exclusive fact-finding function that the founders so carefully enshrined.

At its core, the opinion at hand reflects a disagreement on the facts between the jury, which found there was a meeting of the minds, and the panel, which concluded that there was not. Under the plain language of the Reexamination Clause and principles of appellate review articulated by this Court, the panel was required in these circumstances to defer to the jury. But instead, the Second Circuit panel swept aside the jury verdict, placed itself in the role of a "superjury," substituted its findings of fact based on a limited review of a cold record for those of the jury, and gave no deference to the jury or, for that matter, to the detailed written decision of the highly experienced trial judge who had handled the case for more than six years. Since the issue of whether or not there was an agreement to sell the notes was quintessentially a credibility issue and the testimony of witnesses was critical, the panel's actions from appellate chambers were particularly inappropriate in this case.

In reaching its decision, the panel sifted the evidence and impermissibly drew inferences in favor of the

moving party from "undisputed" facts, something this Court has warned appellate courts they may not do. In addition, the panel ignored, without explanation, substantial evidence in the record favorable to RBC upon which the jury could have reasonably relied for its findings and disregarded credibility determinations in a case where the defendants were repeatedly impeached during trial and credibility was critical. Since there was evidence in the record to support the verdict under the traditional tests for sufficiency applied in this Court and in the Second Circuit, the panel's decision is erroneous and it should be reversed. Moreover, because the panel blatantly ignored the appropriate standard of review under Rule 50 for sufficiency challenges, instead creating a new standard, this case also presents the Court with an opportunity to remind appellate courts of their proper and limited function in reviewing jury verdicts and the need to adhere to precedent of this Court.

First and foremost, the panel usurped the constitutionally-protected role of the jury and engaged in precisely the type of conduct that was feared at the time of the passage of the Bill of Rights. The Reexamination Clause of the Seventh Amendment was adopted in order to prevent appellate courts from reexamining the facts once a jury had determined them. *See Gasperini v. Ctr. for Humanities, Inc.*, 518 U.S. 415, 450-58 (1996) (Scalia, J., dissenting) (recounting in detail the history of the adoption of the Seventh Amendment, including the founders' motivations and concerns) (quoting *United States v. Wonson*, 1 Gall. 5, 28 F. Cas. 745, 750 (No. 16,750) (CC Mass. 1812) (Story, J.)); *see also* Akhil Reed Amar, *Marbury, Section 13, and the*

Original Jurisdiction of the Supreme Court, 56 U. Chi. L Rev. 443, 472-73 (1989) (the framers had a "preference for local juries, who would be more familiar with the parties and witnesses, and thus in a better position to assess their credibility and character. Subsequent adoption of the ... Seventh Amendment[], limiting appellate relitigation of facts found by a local jury, further illustrates the notion that appellate review was generally not seen as authorizing a 'new trial' by the appellate judges.") (citations omitted). The founders, and the Anti-Federalists in particular, believed strongly in the fact-finding role of juries and the adoption of the Seventh Amendment in 1791 reflected the importance attributed to juries. *See id.*; *see also* Debra Lyn Bassett, *"I Lost At Trial—In The Court Of Appeals!": The Expanding Power Of The Federal Appellate Courts to Reexamine Facts*, 38 Houston L. Rev. 1129, 1131 (2001) ("One of the primary motivations behind the Declaration of Independence was the Crown's attempt to encroach upon the right to trial by jury.").

An unbroken line of precedent of this Court for over 150 years properly found, in accordance with the framers' intent, that the Seventh Amendment's Reexamination Clause prohibited appellate courts from reexamining the facts of a case and disturbing a jury verdict. *See Gasperini*, 518 U.S. at 453-54, n.3 (Scalia, J., dissenting) (citing case law); Bassett, *supra* at 1134 & nn.23-24 (2001) (same). As the Court explained in *Lavender v. Kurn*, 327 U.S. 645 (1946):

> Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear. But

> where, as here, there is an evidentiary basis for the jury's verdict, the jury is free to discard or disbelieve whatever facts are inconsistent with its conclusion. And the appellate court's function is exhausted when that evidentiary basis becomes apparent, it being immaterial that the court might draw a contrary inference or feel that another conclusion is more reasonable.

327 U.S. at 653.

Notably, in relying on "undisputed" evidence to draw inferences in favor of the losing party, the panel also ran afoul of Supreme Court authority on this very issue. In *Railroad Company v. Stout*, 17 Wall. (84 U.S.) 657 (1874), this Court prohibited appellate courts from drawing such inferences and explained why that task is left to the jury:

> [I]t is a matter of judgment and discretion, of sound inference, what is the deduction to be drawn from the undisputed facts.
>
> * * *
>
> It is this class of cases and those akin to it that the law commits to the decision of a jury. Twelve men of the average of the community, comprising men of education and men of little education, men of learning and men whose learning consists only in what they have themselves seen and heard, the merchant, the mechanic, the farmer, the laborer; these sit

> together, consult, apply their separate experience of the affairs of life to the facts proven, and draw a unanimous conclusion. This average judgment thus given it is the great effort of the law to obtain. It is assumed that twelve men know more of the common affairs of life than does one man, that they can draw wiser and safer conclusions from admitted facts thus occurring than can a single judge.

17 Wall. at 663-64.

That error is at the very heart of what the panel did in this case. Based on the last recorded call and the fact that the Schneiders had non-public information about a possible corporate event, the panel inferred that there had been no agreement (Pet. App. 14a-16a), discredited RBC's testimony regarding the subsequent conversation and ignored RBC's subsequent actions and other evidence that supported the jury's finding.

Nothing in the Supreme Court's jurisprudence has suggested that appellate courts are free to disregard the Reexamination Clause of the Seventh Amendment, draw inferences in favor of the moving party, make credibility determinations, weigh evidence or substitute their judgment for that of the juries when deciding a Rule 50 motion. Indeed, this Court has explained that Rule 50 was drafted with the requirements of the Seventh Amendment in mind, and its Constitutional requirements are reflected in the Court's articulation of the standards of appellate review under that rule. *Unitherm Food Sys., Inc. v. Swift-Eckrich, Inc.*, 546

U.S. 394, 402, n.4 (2006). Thus, a motion for judgment as a matter of law can be granted by an appellate tribunal only where "'there is no legally sufficient evidentiary basis for a reasonable jury to find for that party on that issue.'" *Reeves*, 530 U.S. at 149 (quoting Fed. R. Civ. P. 50(a)).

A court must draw all reasonable inferences *in favor of the nonmoving party* when reviewing a Rule 50 motion. *Reeves*, 530 U.S. at 150 (citing *Lytle v. Household Mfg., Inc.*, 494 U.S. 545, 554-55 (1990); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 254 (1986); and *Cont'l Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 696, n.6 (1962)). "'Credibility determinations, the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge.'" *Reeves*, 530 U.S. at 150-51 (quoting *Anderson*, 477 U.S. at 255).

A court therefore misapplies the standard of review dictated by Rule 50, and a grant of judgment as a matter of law is improper, where, as in this case, the court impermissibly substitutes its judgment concerning the evidence for that of the jury. *Id.* at 152 (reversing the Fifth Circuit's decision overturning a jury verdict and granting verdict winner judgment as a matter of law where appellate court "disregarded critical evidence favorable to petitioner," "failed to draw all reasonable inferences in favor of petitioner," and "discredited petitioner's evidence"); *Sartor v. Ark. Natural Gas Corp.*, 321 U.S. 620, 628 (1944) ("This Court has said: 'the jury were the judges of the credibility of the witnesses... and in weighing their testimony had the right to determine how much dependence was to be

placed upon it...'") (quoting *Aetna Life Ins. Co. v. Ward*, 140 U.S. 76, 88 (1891)); *Utah Pie Co. v. Cont'l Baking Co.*, 386 U.S. 685, 696 (1967) (vacating a reversal of a jury verdict where the appellate court "almost entirely ignored other evidence which provides material support for the jury's conclusion"). The panel wholly ignored these controlling Supreme Court precedents. Indeed, nowhere in the opinion does the panel cite to *Reeves* or any other opinion of this Court on Rule 50.

In deciding whether to grant certiorari here, the Court should also take into account the fact that absent regular scrutiny by this Court, many appellate tribunals have evidenced a willingness to substitute their judgments for those of jurors to the detriment of the constitutional system approved by the framers. In the absence of such supervision, appellate tribunals are prone to act as "superjurors":

> We now know, at considerable cost to the litigants of the last two decades, something we did not know in 1968 — that left to their own devices, a large number of appellate judges simply cannot resist acting like superjurors, reviewing and revising civil verdicts to assure that the result is precisely the verdict they would have returned had they been in the jury box.

Eric Schnapper, *Judges Against Juries – Appellate Review of Federal Civil Jury Verdicts*, 1989 Wis. L. Rev. 237, 354 (1989). To the extent that jurors become aware of the extent to which their verdicts are being discarded, their service discredited and the Constitution ignored,

the consequences to the jury system would be immeasurable.

Some federal appeals court judges are aware of this concern and understand that the implications of such decisions by appellate courts tossing out jury verdicts go to the integrity of the federal jury system itself. As six judges of the United States Court of Appeals for the Fifth Circuit explained in dissenting from the court's denial of rehearing *en banc* in a case where the panel had "commandeered the jury's role as fact-finder":

> Today the full court countenances the panel majority's usurpation of the jury's constitutionally defined role as fact-finder, irreparably harming the jury system in this circuit.
>
> * * * *
>
> The Seventh Amendment guarantees litigants a right to be tried by jury and the Supreme Court has repeatedly admonished us not to substitute our judgments for those of the jury ...
>
> * * * *
>
> But despite the panel majority's protestations to the contrary, this case remains exactly what it was when the panel first heard it – a vigorously tried case by experienced counsel on both sides before a seasoned trial judge,

> after which the jury returned a verdict that is (or should be) insulated from appellate fact-finding.

Brown v. Parker Drilling Offshore, 444 F.3d 457, 457-58 (5th Cir. 2006) (Stewart, J., dissenting) (citations omitted). *See also Noble v. Brinker Int'l, Inc.*, 391 F.3d 715, 732-37 (6th Cir. 2004) (Clay, J., dissenting); *Dixon v. Wal-Mart Stores, Inc.*, 330 F.3d 311, 323 (5th Cir. 2003) (Dennis, J., dissenting) (noting that majority had "trample[d] upon the jury's role as arbiter of credibility and fact").

As this case aptly illustrates, absent regular supervision by this Court, "no jury verdict is invulnerable" on appeal. *Brown*, 444 F.3d at 458. The petition for certiorari should therefore be granted to curb the abuse of power by appellate courts.

II. The Court Should Grant Certiorari To Provide Needed Guidance To Federal Appellate Courts Regarding The Proper Deference To Be Given To Trial Court Determinations Upholding Jury Verdicts On Sufficiency Of The Evidence Grounds

This Court has held that an appellate court should give deference to the trial judge in determining the sufficiency of the evidence supporting the jury's verdict. Here, the trial judge, in a written opinion, reviewed in detail the substantial evidence presented to the jury that supported its verdict on authority and the existence of an agreement and reaffirmed the jury's findings in its decision denying the Schneider's Rule 50(b) motion. (Pet. App. 25a-33a.) The Second Circuit simply failed

to address these important, first-hand determinations by the trial judge, much less give them any deference as required by this Court's Rule 50 jurisprudence. The panel made its decision, of course, without actually hearing any of the witnesses testify and without the benefit of briefing on the sufficiency issue. The panel essentially made its decision regarding the sufficiency of the evidence in a vacuum.

As the Court explained in *Cone v. West Virginia Pulp & Paper Co.*, 330 U.S. 212 (1947), "[d]etermination of whether a new trial should be granted or a judgment entered under Rule 50(b) calls for the judgment in the first instance of the judge who saw and heard the witnesses and has the feel of the case which no appellate printed transcript can impart." 330 U.S. at 216. This Court has repeatedly noted that courts of appeals, in determining a Rule 50 motion, "should be 'constantly alert' to 'the trial judge's first-hand knowledge of witnesses, testimony, and issues' [and the trial judge's] 'feel' for the overall case." *Weisgram v. Marley Co.*, 528 U.S. 440, 443 (2000) (quoting *Neely v. Martin K. Eby Constr. Co.*, 386 U.S. 317, 325 (1967)); *Unitherm*, 546 U.S. at 401, n.3. As the majority in *Gasperini* observed, "[t]rial judges have the 'unique opportunity to consider the evidence in the living courtroom context,' while appellate judges see only the 'cold paper record.'" 518 U.S. at 438 (internal citations omitted); *Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 445 (2001) (Ginsburg, J., dissenting). Yet decisions of the Courts of Appeals have applied such deference haphazardly and inconsistently, or as is in the instant case, have failed to give the trial court any deference at

all in reviewing whether the evidence was sufficient to support the jury's findings.[23]

As is clear from this Court's jurisprudence, this Court has been called upon numerous times to rein in appellate courts and remind them of the proper role of the jury and the trial court. RBC submits that the time is now ripe for the Court to provide another such reminder, and that the instant case is an appropriate vehicle for the Court to do so. This case is a particularly egregious example of appellate reexamination of the facts, where the panel made its own determinations, disregarded the evidence supporting the jury's verdict, and ignored the trial court's findings regarding the sufficiency of the evidence. Granting certiorari in this case would therefore also allow the Court to provide necessary guidance to the appellate courts regarding

23. Schnapper, *supra* at 300 ("[t]here is today widespread disagreement among the circuit courts regarding whether the views of a trial judge are entitled to any deference in this regard."). *Compare, e.g., ABT Bldg. Prods. Corp. v. Nat'l Union Fire Ins. Co.*, 472 F.3d 99, 113 (4th Cir. 2006) ("As with other legal rulings, we review de novo the conclusions of law on which a trial court's denial of judgment as a matter of law is premised. And we are obliged to accord substantial deference to a district court's interpretation of its own judgment.") (citation omitted), *with, 800 Adept, Inc. v. Murex Secs., Ltd.*, 539 F.3d 1354, 1366 (Fed. Cir. 2008) ("Under Eleventh Circuit law, we review the denial of a motion for judgment as a matter of law without deference, reapplying the same standard applied by the trial court.") (citing *Christopher v. Fla.*, 449 F.3d 1360, 1364 (11th Cir. 2006)) *and Honeywell Int'l v. Hamilton Sundstrand Corp.*, 370 F.3d 1131, 1139 (Fed. Cir. 2004) ("We review the district court's denial of a motion for JMOL without deference, applying the same standard employed by the district court.").

the proper deference to be given to district court decisions, especially where the jury and trial court agree. *See* Schnapper, *supra*, at 300 (noting that "[w]hen a trial judge has concluded that there is sufficient evidence to support a given verdict, and a jury has found the evidence requires that particular verdict, the chance that both judge and jury will have erred is likely to be small, and substantial deference to their concurrent conclusions is certainly appropriate").

This Court should therefore grant the present petition for certiorari to decide whether and to what extent appellate courts should give deference to denials of judgment as a matter of law that uphold jury verdicts on sufficiency of the evidence grounds.[24]

III. The Second Circuit's Opinion Creates Significant Uncertainty As To The Finality Of Securities Transactions

Granting certiorari in this case would also have the significant collateral benefit of eliminating a Second Circuit decision which has created significant uncertainty regarding the enforceability of oral agreements for the sale of securities.

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24. *See also* Highland Petition at 22-23 (arguing that standard of review should be abuse of discretion). Petitioner submits that the adoption by the Court of an abuse of discretion standard in cases where the trial court upholds a jury verdict would be appropriate and would serve a useful purpose in requiring appellate courts to carefully consider trial court determinations.

RBC's contract claim turned on whether the oral agreement made by the Schneiders' agent as to the "size" and "price" for the sale of the notes was binding against the Schneiders. Billions of dollars of securities are traded daily on the securities markets on the basis of brokers' oral agreements as to "size" and "price." As the Second Circuit recognized in certifying to the New York Court of Appeals the question of whether the notes were "securities" (and whether, as a result, an oral agreement to sell the notes could be enforced), imposing uncertainty upon buyers and sellers of promissory notes "risks deterring the trading of promissory notes in financial markets, thereby restricting the free flow of capital," and would be a particularly undesirable result in the nation's financial capital. 460 F.3d at 320. That concern was apparently lost on this panel, which concluded that evidence that the Schneiders' agent had confirmed the "size" and "price" of the notes to be sold to RBC was insufficient to support the jury's finding of an agreement between RBC and the Schneiders (Pet. App. 19a-20a), thus creating precisely that uncertainty.

The panel's ruling that a counterparty must obtain specific assurances of a broker's authority to enter into an agreement as to a specific "size" and "price" of a security (*Id.*), even where the parties' prior course of dealings make clear that the broker was the authorized agent of the principal and had previously made binding offers for the sale of the security, is wholly inconsistent with New York law. The panel's opinion would potentially allow any principal to dishonor oral trades made by an agent that the principal subsequently determined were not in its favor.

The panel's opinion has thus, at a particularly inopportune time in the securities markets, created uncertainty regarding oral trades of securities that the prior circuit opinion and the decision of the New York Court of Appeals sought to eliminate. The potential effect on the free flow of capital underscores the importance of the issues presented here and provides an additional reason to grant certiorari.

CONCLUSION

For the reasons set forth below, the petition for a writ of certiorari should be granted.

New York, New York
November 19, 2010

Respectfully submitted,

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APPENDIX

APPENDIX A — DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DECIDED: JUNE 11, 2010

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 08-4630-cv

607 F.3d 322; 2010 U.S. App. LEXIS 12735

Highland Capital Management LP,

Plaintiff-Appellee,

RBC Dominion Securities Corp.,

Third-Party-Defendant-Counter-Claimant-Appellee,

v.

Leonard Schneider, Leslie Schneider, Scott Schneider, Susan Schneider,

Defendants-Third-Party-Plaintiffs-Counter-Defendants-Appellants,

Jenkins & Gilchrist Parker Chapin LLP,

Defendant.

Appendix A

September 22, 2009, Argued
June 11, 2010, Decided
June 22, 2010, Errata Filed

JUDGES: Before: LEVAL and RAGGI, Circuit Judges, and COTE, District Judge.*

OPINION BY: LEVAL

OPINION

LEVAL, *Circuit Judge*:

Defendants Leonard Schneider ("Schneider") and his children, Leslie, Scott, and Susan Schneider (collectively, "Defendants" or "the Schneiders") appeal from the judgment of the United States District Court for the Southern District of New York (Leisure, *J.*), which held them liable for damages to Plaintiff Highland Capital Management LP ("Highland") and Counter-Claimant RBC Dominion Securities Corp. ("RBC") (jointly, "Appellees"), pursuant to a jury verdict after trial, in the amount of approximately $ 40 million for breach of an alleged contract for the sale of promissory notes. Highland claimed to be the third-party beneficiary of an alleged contract by which the Schneiders, acting through an agent, Glen Rauch Securities ("GRS"), agreed to sell promissory notes of the McNaughton

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* The Honorable Denise Cote of the United States District Court for the Southern District of New York, sitting by designation.

Appendix A

Apparel Group, Inc. ("McNaughton") at fifty-one percent of their face value to RBC. Appellees contend that, after several weeks of negotiation between Glen Rauch of GRS, acting for the Schneiders, and RBC, they concluded the alleged contract in an unrecorded telephone conversation on March 14, 2001. The Schneiders argue, among other contentions, that there could be no contract because their agent, GRS, had neither actual nor apparent authority to make the alleged contract on their behalf. We agree with the Schneiders that the evidence cannot support a finding that Rauch had either actual or apparent authority to make the contract or even that he expressed agreement to sell the notes. We therefore remand to the district court with instructions to set aside the verdict and enter judgment in favor of the Schneiders.

BACKGROUND

The evidence at trial, seen in the light most favorable to Appellees, showed the following. The Schneiders owned and operated two apparel businesses, which they sold to McNaughton in April 1998. In connection with this sale, they received McNaughton's promissory notes for $ 69 million. The Schneiders later became interested in selling the notes. To assist them in making the sale, they engaged GRS, which acted through its principal, Glen Rauch. Rauch contacted RBC as a potential purchaser. Before beginning negotiations in earnest over the sale of the notes, RBC and Rauch executed a Letter Agreement outlining the terms of the negotiations. The agreement stated:

Appendix A

> Reference is made to certain promissory notes [of McNaughton] . . . held by [the Schneiders].
>
> [RBC] understand[s] that Glen Rauch Securities, Inc. ("GRS") represents [the Schneiders] in the possible resale of some or all of the Notes. . . .
>
> . . .
>
> We both understand that the consummation of any transaction remains in the sole discretion and satisfaction of the [Schneiders] and [RBC], including without limitation with respect to price.

Pl.'s Ex. 20. Rauch instructed RBC that its communications concerning the proposed transaction should go through him and that it should not communicate directly with the Schneiders.

RBC intended to purchase the notes incurring only minimal risk by, prior to purchase, arranging to resell them to a third party at a markup over its own purchase price. During the course of its negotiations with the Schneiders, RBC received bids for the notes from Highland and another firm.

Most of the negotiations for RBC's purchase of the notes from the Schneiders were conducted by telephone, between Kenneth Ambrecht of RBC and Rauch.

Appendix A

Because of doubts about McNaughton's solvency, the negotiations discussed prices representing a 35-60% discount from the face value of the notes. The content of the negotiations is largely undisputed, because RBC routinely recorded all telephone calls through its trading desk. The recordings of the conversations between Rauch and RBC show that, in accordance with the Letter Agreement, Rauch always sought authorization from the Schneiders before making any firm proposal to RBC and always made clear to RBC that any proposed terms required the Schneiders' approval. For example, on January 31, 2001, Ambrecht asked Rauch, "[I]s there any way you can get a firm [offer]?" J.A. 693. Rauch responded, "I'll tell [the Schneiders] to make you an offer." *Id.* On February 12, after consulting with the Schneiders, Rauch responded to Ambrecht with a "firm" offer at fifty-nine percent of face value. J.A. 708. After RBC rejected this price, Rauch told Ambrecht on February 26 he was "85 percent sure" he could "trade the whole piece at 54 [percent of face value]," explaining his uncertainty by noting, "I mean you know, dealing with individuals that are [laughter]." J.A. 711. Later that day, Rauch told Ambrecht that the Schneiders would "probably" agree to a price of fifty-three for the entire block of their notes. J.A. 719. However, Rauch also told Ambrecht that he had recently spoken with Leonard Schneider and it was Schneider's position that at "anything less than [fifty-four Schneider was] gonna hold on to 'em for a while." *Id.*

The negotiations continued in similar fashion into March. On March 12, Ambrecht made an offer at 50.5.

Rauch replied, "I'm going to have to reflect back because the last thing I told [the Schneiders] was fifty-one is firm and now I've got to go back and tell them fifty and a half." J.A. 769. When the Schneiders rejected this price, Ambrecht said he would attempt to raise the price to fifty-one, but Rauch told him, "No, at this point, now, they're not going to do anything for a day and a half." J.A. 774. Yet on March 13 Rauch still thought "they'll probably trade them all at fifty-one." J.A. 802. He told Ambrecht, "You know we're not haggling we're done at fifty-one if it gets done and it will probably be tomorrow morning." J.A. 804.

Unbeknownst to Rauch and RBC, however, the Schneiders had received information from McNaughton that significantly altered prospects for payment of the notes, and hence their value. On March 9, McNaughton informed the Schneiders' attorneys that it had received an inquiry from another company about the purchase of McNaughton. The attorneys contacted Schneider the same day, and advised him that "something good was happening with [McNaughton]." Trial Tr. 837. On March 13, the Schneiders met with the attorneys, who "talked about the possibility . . . of a merger or an acquisition of McNaughton . . . and that if that happened, that the notes would . . . be paid 100 cents on the dollar." Trial Tr. 895.

This case turns on the events of the following day, March 14. Rauch and Ambrecht had two recorded phone calls that day. Approximately ten minutes after the second recorded call, RBC called Rauch back, in an

effort to "pin[] Mr. Rauch down." Trial Tr. 375. This call, unlike the others, was not recorded, because it was made from the office of Max Holmes, Co-Head of RBC's High-Yield Group, and not from RBC's trading desk. Appellees contend that during the unrecorded call, RBC and Rauch, on behalf of the Schneiders, formed a contract for the sale of the notes at fifty-one. We discuss in detail below the evidence of the content of all three March 14 phone calls. As explained below, the trial evidence was insufficient to sustain a finding, by a preponderance of the evidence, that Rauch had received authorization from the Schneiders to make the sale, that RBC could have reasonably believed that Rauch had received authorization from the Schneiders to conclude the trade, or that, under the circumstances, RBC could have reasonably interpreted Rauch's words as expressing agreement to sell the notes at fifty-one.

Rauch learned soon after the unrecorded call that the Schneiders had lost interest in selling the notes. On the night of March 14, the Schneiders' attorney, Jim Alterbaum, left a message for Rauch telling him that Alterbaum was "not sure [the] Schneiders want [Rauch] to proceed with phone calls" to RBC and advising Rauch not to "spin his wheel." Pl.'s Ex. 26. The Schneiders then told Rauch they had decided to put on hold any sale of the notes. On March 20, Rauch told Ambrecht, "nothing is going to happen with the bonds probably for five weeks." J.A. 907.

The Schneiders never sold the notes. On April 16, 2001, Jones Apparel Group announced that it would buy McNaughton. On June 19, the notes were paid in full.

This litigation followed, involving claims by RBC and Highland that, during the unrecorded March 14 call between Rauch and RBC's representatives, the Schneiders contracted to sell their McNaughton notes at fifty-one and that they subsequently breached the contract. The Schneiders denied that Rauch had actual authority to make such a sale, that apparent authority for the transaction was ever communicated to the buyers, or that Rauch ever agreed to sell the notes. After a tortuous pretrial history, which we do not recite because it has no pertinence to the issues on this appeal, the case proceeded to trial. The jury found against the Schneiders and awarded damages for breach of contract totaling approximately $ 40 million to RBC and Highland. The district court denied the Schneiders' motion for judgment as a matter of law ("JMOL") or a new trial, and this appeal followed.

DISCUSSION

Under Rule 50 of the Federal Rules of Civil Procedure, a district court may grant JMOL against a party if "a reasonable jury would not have a legally sufficient evidentiary basis to find for the party." Fed. R. Civ. P. 50(a). We review a denial of JMOL de novo. *S.E.C. v. DiBella*, 587 F.3d 553, 563 (2d Cir. 2009). In undertaking this review, "we view the evidence in the light most favorable to the party against which the motion was made." *Metromedia Co. v. Fugazy*, 983 F.2d 350, 361 (2d Cir. 1992), *abrogated on other grounds as noted in Yung v. Lee*, 432 F.3d 142, 147 (2d Cir. 2005). JMOL is properly granted "only when, drawing all

reasonable inferences regarding the weight of the evidence and the credibility of witnesses in favor of the non-movant, a reasonable jury could only have found for the movant." *Kim v. Hurston*, 182 F.3d 113, 117 (2d Cir. 1999) (internal quotation marks and alterations omitted).

Appellees' claims rely on a contract between the Schneiders and RBC, which they contend Rauch agreed to on the Schneiders' behalf during the unrecorded phone call of March 14. The evidence would support a finding of such a contract only if it allowed for a reasonable finding that Rauch had actual authority to make the agreement or if RBC relied on his apparent authority to do so. *Merrill Lynch Interfunding, Inc. v. Argenti*, 155 F.3d 113, 122 (2d Cir. 1998) ("[A]n agent must have authority, whether apparent, actual or implied, to bind his principal."). We conclude that the record contains insufficient evidence to support either finding, or indeed even a finding that Rauch purported to enter a contract without authorization.

I. Actual Authority

Under New York law, an agent has actual authority if the principal has granted the agent the power to enter into contracts on the principal's behalf, subject to whatever limitations the principal places on this power, either explicitly or implicitly. *Ford v. Unity Hosp.*, 32 N.Y.2d 464, 299 N.E.2d 659, 664, 346 N.Y.S.2d 238 (N.Y. 1973) ("An agent's power to bind his principal is

coextensive with the principal's grant of authority.").[1] As we have explained:

> Actual authority is created by direct manifestations from the principal to the agent, and the extent of the agent's actual authority is interpreted in the light of all circumstances attending those manifestations, including the customs of business, the subject matter, any formal agreement between the parties, and the facts of which both parties are aware.

Peltz v. SHB Commodities, Inc., 115 F.3d 1082, 1088 (2d Cir. 1997) (internal quotation marks omitted).

To conclude that Rauch had actual authority to enter a contract to sell the notes at fifty-one, a jury would have to find that the Schneiders authorized a sale of the notes at that price or that they had authorized Rauch to exercise discretion as to the terms of the sale. Leonard Schneider and Rauch, of course, expressly denied that the Schneiders authorized the sale of the notes at fifty-one, Trial Tr. 537-38, 837, and nothing in the record supports a finding that the Schneiders gave Rauch such authorization. At the time of the last recorded call on March 14, ten minutes prior to the unrecorded call, they had not done so, and Appellees put forward no evidence that the Schneiders gave Rauch any further

1. The parties do not dispute that New York law governs the questions of contract and agency law that arise in this appeal.

authorization in the ten intervening minutes. Indeed, it is virtually inconceivable that they would have done so after learning that McNaughton was likely to be acquired and then to pay the notes at their face amount.

Nor does the record contain evidence that Rauch had actual authority to conclude a contract without obtaining the Schneiders' agreement to the terms. The Letter Agreement unequivocally states that "the consummation of any transaction remains in the sole discretion and satisfaction of" the Schneiders and RBC. All the evidence of the behavior of the parties during the course of the negotiations further confirmed that the Schneiders withheld authorization from Rauch to conclude a contract on their behalf without their consent to the terms. Rauch presented firm offers to RBC only after obtaining the Schneiders' permission to do so, and he presented RBC's offers to the Schneiders before responding to them. There was, therefore, no basis upon which a jury could conclude that Rauch had received actual authorization to enter into a contract without the Schneiders' express agreement to its terms, which he never received.

Appellees' primary argument in support of a finding that Rauch had actual authority to enter into a contract for a sale of the notes at fifty-one is that "customs of business," *Peltz*, 115 F.3d at 1088, imply that Rauch had actual authority to "accept a price on behalf of his clients." Pl.'s Br. at 38. They argue, "[T]here is no evidence that [the Letter Agreement] foreclosed the possibility that Rauch would be communicating the

Schneiders' approval of the transaction." *Id.* This may be true, but the crucial question is not whether Rauch could "accept a price" on behalf of the Schneiders, but whether he could do so without their authorization. Likewise, the question is not whether Rauch was authorized to "communicat[e] the Schneiders' approval," but whether he had received the Schneiders' approval. There was no evidence that Rauch had authorization to exercise his own discretion on behalf of his principals as to the terms of the transaction. To the contrary, all the evidence showed that Rauch had no actual authority to contract except upon receipt of the sellers' approval of the terms, and there was no evidence that he had received such approval.

II. Apparent Authority

Appellees also contend that Rauch had apparent authority to bind the Schneiders to a contract for the sale of the notes at fifty-one. Where an agent lacks actual authority, he may nonetheless bind his principal to a contract if the principal has created the appearance of authority, leading the other contracting party to reasonably believe that actual authority exists. "Apparent authority exists when a principal, either intentionally or by lack of ordinary care, induces [a third party] to believe that an individual has been authorized to act on its behalf." *Peltz*, 115 F.3d at 1088 (internal quotation marks omitted); *see also Wells Fargo Home Mortgage, Inc. v. Hiddekel Church of God, Inc.*, 1 Misc. 3d 913A, 781 N.Y.S.2d 628, 628 (Sup. Ct. 2004) ("'Essential to the creation of apparent authority are

words or conduct of the principal, communicated to a third party, that give rise to the appearance and belief that the agent possesses authority to enter into a transaction.'" (quoting *Standard Funding Corp. v. Lewitt*, 89 N.Y.2d 546, 678 N.E.2d 874, 877, 656 N.Y.S.2d 188 (N.Y. 1997))). However, "[t]he mere creation of an agency for some purpose does not automatically invest the agent with 'apparent authority' to bind the principal without limitation." *Ford*, 299 N.E.2d at 664. A party cannot claim that an agent acted with apparent authority when it "knew, or should have known, that [the agent] was exceeding the scope of its authority." *Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 33 (2d Cir. 2001).

To conclude that Rauch had apparent authority to make the contract, a jury would need to find that the Schneiders induced the reasonable belief by RBC that Rauch made the contract having received the authorization of the Schneiders to do so. *See Peltz*, 115 F.3d at 1088. No evidence suggests that the Schneiders did anything to induce RBC to believe that Rauch was authorized to enter an agreement without their specific assent to its terms. The Letter Agreement expressly advised Appellees that he could not, and Rauch repeatedly confirmed this limitation on his authority throughout his negotiations with RBC. For example, on January 31, when Ambrecht asked for a firm offer, Rauch replied, "I'll tell [the Schneiders] to make you an offer." J.A. 693. He responded with a firm offer twelve days later, after consulting with the Schneiders.

Rauch had apparent authority, therefore, to conclude an agreement only if the Schneiders induced RBC to reasonably believe that the Schneiders had agreed to make a deal on the terms offered. We assume arguendo that by authorizing Rauch to negotiate with RBC on their behalf, the Schneiders gave Rauch apparent authority to communicate their assent either expressly or by implication (even if they had not in fact assented). Nevertheless, in light of the evidence of the negotiations preceding the unrecorded March 14 phone call, Appellees failed to introduce sufficient evidence for a reasonable finding, by a preponderance of the evidence, that RBC reasonably believed that Rauch had received authorization from the Schneiders to sell the notes at fifty-one.

The recordings of the first two calls on March 14 make clear that, at the times those calls took place, Rauch lacked authority to sell the notes at fifty-one. In the first call, at 9:40 a.m., Rauch told Ambrecht that he had talked to the Schneiders that morning, but that "they didn't even mention" the deal to sell the notes and he was "not going to know before noon" whether the Schneiders wanted to go forward with the trade. J.A. 821. Rauch explained that he could not conclude an agreement until he spoke with the Schneiders, even though Rauch "would have done the trade yesterday." *Id.* Ambrecht asked whether Rauch thought that the Schneiders had "changed their mind," to which Rauch replied, "No, absolutely not." *Id.* Ambrecht asked why they "just don't say just do it then," to which Rauch responded, "Well, I will let you know as soon as I know . . . ." *Id.*

Appendix A

In the second recorded call, at 2:18 p.m., Rauch continued to make clear that he could not conclude the deal. Ambrecht told Rauch that he was receiving complaints from one of the firms to which RBC planned to sell the notes. He explained that the agent of the other firm had asked him, "[Y]ou got me to step up and now you're not giving me closure here, now what is going on?" J.A. 837. Rauch responded that he "got a call in to the [Schneiders'] attorney and the attorney's supposedly going to call me back." *Id.* Ambrecht asked whether "we need the attorney for a verbal [agreement]" and Rauch insisted that a verbal agreement was not possible at that point because "[the Schneiders] said they wanted to talk to the attorney." *Id.* He explained, "before I say a word, [the attorney's] going to put the words in my mouth." *Id.* Ambrecht asked whether the Schneiders "more or less see if they can like want this, agree to it, it sounds like now?" *Id.* But Rauch responded, "You know, I don't want to go out on a limb because uh I don't know how he's going to tell me, how this goes, you know." *Id.* Ambrecht asked whether Rauch expected to hear from the lawyer soon, to which Rauch replied, "No, no, f[*]cking attorney . . . if he calls me at five thirty, I'll be delighted." J.A. 839. Ambrecht asked whether "it will be okay then to try to do the trade" if the lawyers settled on the wording, but Rauch was noncommittal, saying "Yeah, I mean the, based on the, you know, how he tells me to present it, and you know under what conditions and so forth." J.A. 840. Ambrecht again complained that he was receiving "a lot of pressure" to conclude the deal, and Rauch replied, "Hey, if we agreed to the terms two weeks ago,

right now we'd go out for dinner tonight . . . [a]nd say I'm glad that's done." J.A. 841. The call ended with Rauch promising, "I'll call you as soon as I know." J.A. 842.

In light of this undisputed evidence of the content of the recorded calls, none of the evidence of the content of the subsequent unrecorded call supports a reasonable belief on RBC's part that Rauch had received authorization from the Schneiders to make the deal in the intervening minutes. Three people participated in the call on RBC's behalf: Ambrecht, Holmes, and Peter Parent, another Co-Head of the High-Yield Group. Neither Holmes nor Parent had been part of the previous negotiations between RBC and Rauch. Although all the participants in the unrecorded call testified at trial as to the content of the call, Parent's account is the only one that provides even an arguable basis for a finding of apparent authority, and it too is insufficient in light of the other undisputed evidence. Parent testified, "I remember . . . that Glen confirmed size and price with us, 69 million at 51, which means that we had a transaction. . . . Glen was going to get the lawyers to send us a confirm so that we could go to a written form of contract." Tr. 151. However, that the "size and price" under discussion were "69 million at 51" was not in dispute. The issue was whether, under the circumstances, RBC could reasonably understand Rauch to be telling it that the Schneiders had agreed to that price. Parent's addition, "which means that we had a transaction," was a statement about his own thought processes — not Rauch's statements. His belief

that they had a contract is insufficient unless the belief was reasonably attributable to Rauch's statements.

Parent's further addition that "Glen was going to get the lawyers to send us a confirm so that we could go to a written form of contract," was ambiguous and in the context also insufficient. *In the absence of other evidence of the communications between RBC and Rauch*, such a statement by a broker in Rauch's position could perhaps reasonably have been understood by RBC as implying that he had received authorization for the contract and that they had a deal. Such ambiguous words, however, could also have represented nothing more than Rauch's expression of his determination to get the deal done. But while either interpretation might be reasonable if the statement were viewed in isolation, the same is not true once the undisputed evidence of the prior negotiations is taken into account. Highland and RBC are entitled to have us consider the evidence in the light most favorable to them in determining whether the jury's verdict in their favor was based on legally sufficient evidence, but we may not disregard undisputed evidence that bears on the interpretation of ambiguous matters. *See Tomassi v. Insignia Fin. Group, Inc.*, 478 F.3d 111, 115-17 (2d Cir. 2007) (evaluating the sufficiency of evidence "in the context of all the evidence"). To prevail on the apparent authority theory, Appellees needed evidence that, taken together with the undisputed evidence of the negotiations, could support a finding that it was more probable than not that RBC reasonably understood Rauch to be saying that he had at last received authorization.

Appendix A

In the context of the other evidence — particularly the undisputed content of the previous recorded calls — a jury could not reasonably find it more probable than not that RBC reasonably understood the words Parent attributed to Rauch to constitute Rauch's affirmation that he had at last received authorization to make the deal. Only ten minutes earlier, Rauch told RBC that he did not have approval for a sale at fifty-one and that he could not agree to the sale unless he received such approval from either the Schneiders or their lawyers. He said that the Schneiders' attorney would be dictating what he should say and that he did not expect to hear anything before the end of the day. He made clear that he hoped to receive the approval and would call RBC immediately if he did. Rauch, however, did not call RBC. And when RBC called him after the passage of only ten minutes, nothing in their conversation reported by any of the participants suggested that in that intervening ten minutes anything had changed. [2]

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2. The testimonies of Holmes, Ambrecht, and Rauch are also insufficient to support a finding of apparent authority. Holmes and Ambrecht did not attribute any words to Rauch that would have led RBC to reasonably believe the Schneiders had authorized Rauch to sell at fifty-one, asserting only their own impressions that a deal had been reached. Indeed, Holmes testified that after the call ended he "shrugged and said, I guess we'll have to wait until tomorrow for Mr. Rauch to call us back." Trial Tr. 401-02. Nor does RBC receive any comfort from Rauch's testimony about the call. He testified that he explicitly told RBC that they did not have a deal:

> Max [Holmes] said, Glen, where are we on the transaction? I said, What do you mean? He said, Do

(Cont'd)

Notwithstanding that, upon a different record that contained no other evidence of the known limits of his authority, a broker's statement that he would "get the lawyers to send a confirm" relating to a specified size and price might well be a sufficient basis to support a reasonable belief that the broker had his principal's approval and that the deal was done, we cannot disregard the undisputed evidence of the context. In the context of the extensive undisputed evidence of the dealings between Rauch and RBC, that single ambiguous line Parent attributed to Rauch could not sufficiently establish apparent authority. A jury could not reasonably find it more probable than not that RBC reasonably believed, based on that single sentence, that in the ten minutes since the prior recorded call Rauch had finally received the long-awaited authorization to do the $35 million transaction, when Rauch said nothing to suggest that since ten minutes earlier the circumstances had changed. While it is not inconceivable that Rauch's unclear reference to having lawyers send a confirm could have meant that he had received authorization, the complete undisputed circumstances of the call made it so improbable that this was his meaning that RBC could not reasonably draw that

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(Cont'd)

> we have size and price? I said, No, we don't have size and we don't have price. He said, Then you mean we're nowhere? I said, Yeah, unfortunately that's where we are. He said, OK, that's it, good-bye. And that was it.

Tr. 539

inference. A jury could not reasonably conclude, by a preponderance of the evidence, that RBC relied on Rauch's apparent authority to make the deal.

For the same reason, the evidence was insufficient to support a reasonable finding that Rauch expressed agreement to sell the notes during the unrecorded March 14 call or that RBC reasonably construed Rauch's words as expressing agreement to sell at fifty-one. We conclude that, taking all ambiguous or disputed evidence in the light most favorable to the Appellees, but construing it in light of the extensive undisputed evidence, a jury could not reasonably find it more probable than not that Rauch had received authorization to sell at fifty-one, that RBC reasonably believed he had received authorization to sell at fifty-one, or that RBC reasonably understood his words as expressing agreement to sell at fifty-one.

We conclude that the Schneiders were entitled to judgment as a matter of law. We therefore reverse the judgment in favor of Highland and RBC and remand for entry of judgment in favor of the Schneiders.

CONCLUSION

The district court's order denying Defendants' motion for judgment as a matter of law is hereby REVERSED, and the case is REMANDED with instructions to enter judgment in favor of Defendants.

APPENDIX B — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK FILED AUGUST 20, 2008

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

02 Civ. 8098 (PKL)

2008 U.S. Dist. LEXIS 63874

HIGHLAND CAPITAL MANAGEMENT, L.P.,

Plaintiff,

- against -

LEONARD SCHNEIDER, LESLIE SCHNEIDER, SCOTT SCHNEIDER, and SUSAN SCHNEIDER,

Defendants.

LEONARD SCHNEIDER, LESLIE SCHNEIDER, SCOTT SCHNEIDER, and SUSAN SCHNEIDER,

Third-Party Plaintiffs,

- against -

RBC CAPITAL MARKETS CORPORATION f/k/a/ RBC DOMINION SECURITIES CORPORATION,

Third-Party Defendant and Third-Party Counterclaimant.

Appendix B

OPINION AND ORDER

LEISURE, District Judge

Following a jury trial on the merits, the Court entered judgment against defendants Leonard Schneider ("Leonard"), Leslie Schneider ("Leslie"), Scott Schneider ("Scott"), and Susan Schneider ("Susan") (collectively "defendants" or "the Schneiders") awarding damages to plaintiff Highland Capital Management, L.P. ("Highland") and third-party defendant and counterclaimant, RBC Capital Markets Corporation, formerly known as RBC Dominion Securities Corporation ("RBC").[1] Defendants now bring a motion for judgment as a matter of law, or in the alternative, for a new trial. The parties also request that the Court amend the judgment — plaintiffs bring a joint motion to correct the judgment and defendants bring a motion to alter or amend the judgment. For the following reason, defendants' motions are DENIED and plaintiffs' motion is GRANTED.

BACKGROUND

Highland brought this action against defendants for their refusal to sell certain promissory notes (the "Notes"), valued at $69 million, to Highland and RBC.

1. Prior to the start of trial, the Court, after consulting with the parties, began referring to RBC as a "plaintiff" to avoid confusing the jury because only claims against the Schneiders remained after the Court's summary judgment decision. The Court will continue with this practice in this Order and Opinion. Thus, Highland and RBC are collectively referred to as "plaintiffs".

Appendix B

The factual background of this case is explained in detail in the Court's July 26, 2005 and January 16, 2008 summary judgment opinions, familiarity with which is assumed.[2] *See Highland Capital Mgmt., L.P. v. Schneider*, 533 F. Supp. 2d 345, 347-50 (S.D.N.Y. 2008); *Highland Capital Mgmt., L.P. v. Schneider*, No. 02 Civ. 8098, 2005 WL 1765711, at *1-9 (S.D.N.Y. July 26, 2005). Any additional relevant facts are included in the discussion below.

Following this Court's determination of the parties' pre-trial motions, RBC's two remaining claims at trial were for (1) breach of duty to negotiate, and (2) breach of oral contract to sell the promissory notes. Both claims were premised upon the allegation that defendants, through their agent, Glen Rauch ("Rauch") or Glen Rauch Securities ("GRS"), entered into an agreement to sell the Notes to RBC. Additionally, Highland claimed that it was an intended third-party beneficiary of the purported contract between defendants and RBC.

Following a three-week trial, the jury returned a verdict in favor of plaintiffs on March 6, 2008. The Court's original judgment was entered on March 11,

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2. Following this Court's 2005 summary judgment opinion, the Second Circuit certified a question to the New York Court of Appeals and subsequently vacated and remanded this Court's judgment with respect to three of Highland's claims. *See Highland Capital Mgmt., L.P. v. Schneider*, 485 F.3d 690 (2d Cir. 2007); *Highland Capital Mgmt., L.P. v. Schneider*, 460 F.3d 308 (2d Cir. 2006); *see also Highland Capital Mgmt., L.P. v. Schneider*, 8 N.Y.3d 406, 834 N.Y.S.2d 692, 866 N.E.2d 1020 (2007).

2008 and an amended judgment, which corrected typographical errors and identified defendants by name, was entered on March 17, 2008 (collectively the "Judgment"). The Judgment awards $22,456,757.50 to Highland and $17,710,817.33 to RBC, as well as pre-judgment interest from June 19, 2001 through March 10, 2008.

On March 25, 2008, plaintiffs filed a joint motion to correct the judgment, which defendants oppose. On March 26, 2008, defendants filed a motion to alter or amend the judgment, as well as a motion for judgment as a matter of law, or in the alternative, for a new trial, which plaintiffs oppose.

DISCUSSION

I. *Defendants' Motion for Judgment as a Matter of Law, or in the Alternative, for a New Trial*

A. *Motion for Judgment as a Matter of Law*

1. *Standard Under Rule 50(b)*

Defendants move for judgment as a matter of law pursuant to Federal Rule of Civil Procedure 50(b). The Court may properly grant a motion for judgment as a matter of law under Rule 50(b) "only if there is 'such a complete absence of evidence supporting the verdict that the jury's findings could only have been the result of sheer surmise and conjecture, or such an overwhelming amount of evidence in favor of the movant that

reasonable and fair minded [persons] could not arrive at a verdict against [the moving party].'" *Stratton v. Dep't for the Aging for the City of New York*, 132 F.3d 869, 878 (2d Cir. 1997) (quoting *LeBlanc-Sternberg v. Fletcher*, 67 F.3d 412, 429 (2d Cir. 1995)); *see also Weissman v. Dawn Joy Fashions, Inc.*, 214 F.3d 224, 233 (2d Cir. 2000).

In ruling on a Rule 50(b) motion, the court is "required to 'consider the evidence in the light most favorable to the party against whom the motion was made and to give that party the benefit of all reasonable inferences that the jury might have drawn in his favor from the evidence. The court cannot assess the weight of conflicting evidence, pass on the credibility of the witnesses, or substitute its judgment for that of the jury.'" *LeBlanc-Sternberg*, 67 F.3d at 429 (quoting *Smith v. Lightning Bolt Prods., Inc.*, 861 F.2d 363, 367 (2d Cir. 1988)). "[W]hatever its own view of the facts may [be], the court [is] not entitled to substitute its view for adequately supported findings that were implicit in the jury's verdict." *Id.* at 430.

2. *Sufficiency of the Evidence*

The Court begins by rejecting defendants' arguments that they are entitled to judgment as a matter of law because the jury's verdict was not supported by the evidence. The Court's review of the record indicates that there is substantial evidence in support of the verdict.

Appendix B

a. *Agreement to Sell the Notes*

Defendants argue that plaintiffs did not present sufficient evidence for "a reasonable jury determination that the Schneiders and RBC entered into an oral agreement for the sale of Notes." (Defs.' Memo. of Law at 11.) In support of their assertion, defendants cite testimony from Rauch and each of the defendants, as well as taped telephone conversations between Rauch and RBC. Defendants further contend that testimony presented by plaintiffs was inconsistent regarding the existence of a contract and RBC's failure to record the agreement.

Defendants have failed to demonstrate that the jury's finding that a contract existed was not adequately supported by evidence. Despite defendants' testimony in support of their position, their credibility was challenged more than once during the course of the trial. Such challenges included impeachment through the introduction of prior deposition testimony, as well as contradictory evidence presented by plaintiffs. Several of plaintiffs' witnesses, including Peter Parent ("Parent"), Ken Ambrecht ("Ambrecht"), and Max Holmes ("Holmes"), testified that an agreement was reached during an untaped telephone call on March 14, 2001. Plaintiffs presented additional evidence in support of this testimony, such as evidence regarding RBC's actions following the agreement and Rauch's letter to Leonard regarding payment of a fee for his work on the transaction. Plaintiffs presented sufficient evidence that there was "a meeting of the minds, demonstrating the

parties' mutual assent and mutual intent to be bound." *Oscar Prods., Inc. v. Zacharius*, 893 F. Supp. 250, 255 (S.D.N.Y. 1995). A reasonable jury could infer that defendants and RBC entered into an agreement for the sale of the Notes.

b. *Essential Terms*

Defendants contend that there was insufficient evidence of a meeting of the minds on essential terms of the agreement between defendants and RBC. Specifically, defendants argue that representations, warranties, and conditions were essential to the agreement. (Defs.' Memo. of Law at 14; Defs.' Reply at 25.) Defendants, however, have failed to show that there was a lack of evidence presented on this issue from which a reasonable jury could conclude that there was a meeting of the minds on essential terms. Plaintiffs presented witnesses, including Parent and Ambrecht, who testified that "size and price" were the only essential terms of this agreement. Based on the evidence, the jury could reasonably conclude that there was a meeting of the minds regarding all essential terms of the agreement. *See, e.g., Cinema N. Corp. v. Plaza at Latham Assocs. & Hoyt's Cinema*, 867 F.2d 135, 140 (2d Cir. 1989)

c. *Oral Agreement*

Defendants argue that the evidence demonstrated that "the parties intended that no agreement would be reached until it was reduced to a written agreement."

(Defs.' Memo. of Law at 15.) The factors to be considered in determining whether the parties intended to be bound absent a written agreement are: "(1) whether there has been an express reservation of the right not to be bound in the absence of a writing; (2) whether there has been partial performance of the contract; (3) whether all of the terms of the alleged contract have been agreed upon; and (4) whether the agreement at issue is the type of contract that is usually committed to writing." *Winston v. Mediafare Entm't Corp.*, 777 F.2d 78, 80 (2d Cir. 1986). Defendants have failed to meet their burden of showing that no reasonable jury could find that a binding agreement to sell the Notes could be made orally.

Regarding the first factor, defendants contend that the January 5, 2001 Letter Agreement between GRS and RBC, along with evidence that RBC's representatives acknowledged that the transaction required a written agreement, precluded the jury from finding that there was an oral agreement. In reference to a possible resale of the Notes, the Letter Agreement between GRS and RBC states that "any such transaction is subject to definitive documentation in compliance with applicable law. . . ." (Pls.' Exh. 20.) However, plaintiffs presented evidence that the Letter Agreement merely indicated that the trade would ultimately be documented, and not that documentation was required to establish the agreement. Gerald A. Guild ("Guild"), plaintiffs' expert, testified regarding industry custom and practice, (Trial Tr. at 607:5-608:24), and Holmes, the drafter of the Letter Agreement, testified regarding his purpose for including the language and his interpretation of it. (Trial Tr. at 363:21-364:19.)

Defendants contend that the second factor also suggests that the parties did not intend to be bound absent a writing because there was no performance. (Defs.' Memo. of Law at 18.) Plantiffs, however, presented evidence from which the jury could reasonably conclude that RBC had partially performed under the agreement, including taking steps to complete the transaction as a riskless principal, such as hiring a lawyer. (Trial Tr. at 158:12-18.) Regarding the third factor, as discussed above, plaintiffs presented evidence that the parties had agreed on the essential terms of the contract. Finally, regarding the fourth factor, plaintiffs presented evidence, such as Guild's testimony, from which the jury could reasonably conclude that this was not the type of agreement that was usually committed to writing. (Trial Tr. at 607:10-608:24, 617:21-618:2.) Thus, there was sufficient evidence from which the jury could reasonably conclude that a binding agreement to sell the Notes could be made orally.

d. *Intended Third-Party Beneficiary*

Defendants assert that there was insufficient evidence to support Highland's claim as an intended third-party beneficiary of the agreement between defendants and RBC. As the Court previously stated, "[i]n order to claim third party beneficiary status, [Highland] must allege: (1) the existence of a valid and binding contract between other parties, (2) that the contract was intended for [its] benefit and (3) that the benefit to [it] is sufficiently immediate, rather than incidental, to indicate the assumption by the contracting

parties of a duty to compensate [it] if the benefit is lost." *Highland Capital Mgmt.*, 2005 WL 1765711, at *19 (internal quotations omitted). An intended third-party beneficiary's identity need not be expressed in the agreement, but the parties to the contract must demonstrate their intention to benefit a third party in the agreement. *See McPheeters v. McGinn, Smith & Co., Inc.*, 953 F.2d 771, 773 (2d Cir. 1992); *Trans-Orient Marine Corp. v. Star. Trading & Marine, Inc.*, 925 F.2d 566, 573 (2d Cir. 1991); In re *Gulf Oil/Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712, 733 (S.D.N.Y. 1989).

Defendants assert that Highland failed to present sufficient evidence to support the jury's finding that it was an intended third-party beneficiary. They claim that Highland presented no evidence that defendants and RBC recognized that the sale was to benefit a customer and that RBC actually sought to hide its agreement with Highland from defendants. (Defs.' Reply at 45-46.) Considering the record, a reasonable jury could conclude that Highland was an intended third-party beneficiary of the agreement between defendants and RBC. Highland did not have to show that defendants knew Highland's identity, but only that the contract evidenced RBC's and defendants' intention to benefit a third party. Highland presented evidence that RBC was acting as a riskless principal and that Rauch was aware that RBC would immediately trade the Notes to a buyer.

e. *Agents' Authority*

Defendants contend that there was insufficient evidence to establish that Rauch had actual or apparent

authority to bind defendants and that Leonard had actual or apparent authority to bind Leslie, Susan, or Scott. Actual authority is conferred, explicitly or impliedly, from the principal to the agent. *See Seetransport Wiking Trader Schiffarhtsgesellschaft MBH & Co. Kommanditgesellschaft v. Republic of Romania*, 123 F. Supp. 2d 174, 185-86 (S.D.N.Y. 2000) (Sprizzo, J.). An agent has apparent authority if "(1) [the] principal was responsible for the appearance of authority in the agent to conduct the transaction in question, and (2) the third party reasonably relied on the representations of the agent." *Highland Capital Mgmt.*, 2005 WL 1765711, at *10 (internal quotations and citations omitted).

Defendants assert that plaintiffs presented no evidence that Rauch was authorized to sell the Notes on behalf of defendants and that he was, at most, authorized to negotiate on their behalf. (Defs.' Reply at 32.) Defendants argue that the jury could not reasonably conclude that defendants created the appearance of authority when the Letter Agreement required that defendants approve any sale. (Defs.' Reply at 32-33.) They also claim that there was no evidence that defendants did anything to give the appearance to RBC that Rauch had the authority to enter into an agreement on their behalf. (Defs.' Reply at 35-36.)

Contrary to defendants' assertion, there was sufficient evidence that Rauch had authority to bind defendants. Plaintiffs presented evidence that the Letter Agreement did not exclude Rauch from having

the authority to bind defendants. Additionally, they presented evidence demonstrating that it was industry custom and practice for brokers, like Rauch, to routinely enter into binding agreements on behalf of their clients. Plaintiffs presented evidence that Rauch, who was the family's broker for a number of years, considered bids, including "firm" offers, for the Notes on behalf of defendants in dealing with RBC. (Trial Tr. at 521:5-19, 525:4-7.) Indeed, there was evidence that defendants directed that RBC communicate with defendants only through Rauch. (Pls.' Exh. 50.) Thus, the jury reasonably concluded that Rauch had the authority to bind defendants to a sale of the Notes.

Similarly, plaintiffs presented sufficient evidence at trial for the jury reasonably to conclude that Leonard was the agent of Leslie, Susan, and Scott. Testimony from defendants and Rauch indicated that Rauch routinely communicated with Leonard regarding trades for Leslie, Susan, and Scott. Regarding the Letter Agreement, Rauch stated that Leonard authorized him to sign on behalf of Leonard, Leslie, Susan, and Scott. (Trial Tr. at 499:4-7.) Rauch also stated that Leonard "usually spoke for his children." (Trial Tr. at 491:10.) Additionally, attorney James Alterbaum represented all defendants and approved the Letter Agreement. Finally, plaintiffs introduced Leonard's deposition testimony to impeach his testimony at trial on this issue. Therefore, plaintiffs put forth sufficient evidence for the jury to find that Rauch had authority to bind defendants and that Leonard had authority to bind Leslie, Susan, and Scott.

In light of the record, the Court finds that the jury's verdict was supported by substantial evidence and defendants' motion for judgment as a matter of law must be denied.

B. *Motion for a New Trial*

"In ruling on a Rule 59 motion a court makes the same type of inquiry as on a motion for judgment as a matter of law, but imposes a less stringent standard." *Fowler v. New York Transit Auth.*, No. 96 Civ. 6796, 2001 WL 83228, *2 (S.D.N.Y. 2001) (citing *Katara v. D.E. Jones Commodities, Inc.*, 835 F.2d 966, 970 (2d Cir. 1987); *Newmont Mines Ltd. v. Hanover Ins. Co.*, 784 F.2d 127, 132 (2d Cir.. 1986)). "The decision whether to grant a new trial on the ground that the verdict was against the weight of the evidence is committed to the sound discretion of the district court." *U.S. E. Telecomms., Inc. v. U.S. W. Commc'ns Servs., Inc.*, 38 F.3d 1289, 1301 (2d Cir. 1994) (internal quotations and citation omitted). In exercising its discretion, "[a] trial court should grant such a motion when convinced that the jury has reached a seriously erroneous result or the verdict is a miscarriage of justice," *Katara*, 835 F.2d at 970, or the verdict is "against the weight of the evidence." *U.S. E. Telecomms., Inc.*, 38 F.3d at 1301. "While the Court need not necessarily weigh the evidence in the light most favorable to the non-moving party, disagreement with the verdict alone is insufficient to justify ordering a new trial." *Muller v. Costello*, 997 F. Supp. 299, 302 (N.D.N.Y. 1998) (citing *Mallis v. Bankers Trust Co.*, 717 F.2d 683, 688-89 (2d Cir. 1983)).

Appendix B

1. *Damages*

In support of their motion for a new trial, defendants make various challenges to the damages awards, claiming that the damages were inconsistent with controlling law, unsupported by evidence, the result of errors in the jury charge, and clearly excessive. (Defs.' Memo. of Law at 28.)

a. *General Damages Award*

First, the Court addresses defendants' argument that the general damages award was contrary to controlling law and not supported by the evidence. Damages for breach of contract should place the aggrieved party in the same economic position it would have been in had the breaching party fully performed. *See Commerce Funding Corp. v. Comprehensive Habilitation Servs., Inc.*, No. 01 Civ. 3796, 2005 WL 447377, at *18 (S.D.N.Y. Feb. 24, 2005) (Leisure, J.); *see also Contemporary Mission, Inc. v. Bonded Mailings, Inc.*, 671 F.2d 81, 84 (2d Cir. 1982). A plaintiff need not prove damages with mathematical precision, but must demonstrate damages with reasonable certainty. *See, e.g., Exodus Partners, LLC v. Cooke*, No. 04 Civ. 10239, 2007 WL 120053, at *14 (S.D.N.Y. Jan. 17, 2007). In this case, the jury was asked to "calculate damages by determining the difference between the contract price for the Notes that the parties agreed to and the value of the Notes at the time of the breach." (Jury Charge at 55.)

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Defendants contend that the jury's damages award improperly takes into account post-breach events; specifically, the Jones-McNaughton merger and the subsequent payment on the Notes at face value to defendants.[3] Defendants also argue that the only evidence of market value at the time of the breach was Highland's 52.5 cent offer to RBC. Defendants contend that any material nonpublic information that they possessed at the time of the breach was uncertain and should have no bearing on the Notes' market value.

Assessing damages is a factual inquiry for the jury. *See Ismail v. Cohen*, 899 F.2d 183, 186 (2d Cir. 1990) ("It is well settled that calculation of damages is the province of the jury."). Here, there was sufficient evidence for the jury to conclude that the value of the Notes at the time of the breach was the full face value. The jury could reasonably conclude that the material nonpublic information possessed by defendants impacted the value of the Notes at the time of the breach. Similarly, a reasonable jury calculating damages could conclude that it was irrelevant that the individuals who were actually negotiating the agreement did not possess this material

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3. There was evidence presented at trial that in March 2001 defendants obtained material nonpublic information regarding a potential deal between the issuer of the Notes, McNaughton Apparel Group, Inc., formerly known as Norton McNaughton, Inc. ("McNaughton") and Jones Apparel Group ("Jones"). On April 16, 2001, it was publicly announced that Jones had agreed to purchase McNaughton. The Notes were paid out in full on June 19, 2001, with defendants receiving $69 million plus interest.

nonpublic information. (Defs.' Reply at 12.) The jury's general damages award is supported by law and the evidence presented at trial, and provides reasonable compensation for defendants' breach.

b. *Jury Charge*

Defendants contend that the Court's failure to include certain of their proposed jury instructions allowed the jury to incorrectly calculate damages, resulting in substantial error. The Court is granted discretion in the wording of jury instructions, "so long as the instructions, taken as a whole, do not mislead the jury as to the proper legal standard, or . . . adequately inform the jury of the law." *See Parker v. Sony Pictures Entm't, Inc.*, 260 F.3d 100, 106-07 (2d Cir. 2001) (internal quotations omitted). "A jury instruction is erroneous if the instruction misleads the jury as to the proper legal standard, or it does not adequately inform the jury of the law, but such an error will not be grounds for reversal unless taken as a whole, the jury instructions gave a misleading impression or inadequate understanding of the law." *Owen v. Thermatool Corp.*, 155 F.3d 137, 139 (2d Cir. 1998) (internal quotations omitted). The jury was instructed to calculate damages at the time of the breach, based on the difference between the contract price and the value of the notes at the time of the breach. Considering the charge as a whole, the Court's wording adequately informed the jury of the law and was not misleading.

c. *Benefit of the Bargain Damages*

Defendants argue that the jury improperly awarded damages to RBC for Leonard's $23.6 million Note, which was to be sold to Fidelity. In ruling on the parties' motions *in limine*, the Court held that RBC could not assert a claim on behalf of Fidelity. *See Highland Capital Mgmt., L.P. v. Schneider*, 551 F. Supp. 2d 173, 194-95 (S.D.N.Y. 2008) (Leisure, J.). The jury's award here, however, is not in contravention of the Court's *in limine* ruling. RBC's breach of contract claim was for the full $69 million of Notes, which was separate from any claims brought by third parties like Highland and Fidelity. Thus, the jury's award was not erroneous.

d. *Consequential Damages*

In addition to general damages, the jury awarded RBC $5 million in consequential damages for lost profits stemming from defendants' breach. Defendants assert that the award of consequential damages was contrary to law because "there was no evidence from which the jury could rationally have found that the loss of future Fidelity business, or the loss of profits from any such future business, was within the contemplation of the Schneiders (or Rauch) at the time that the alleged oral agreement was made." (Defs.' Memo. of Law at 43.) Additionally, defendants claim that RBC failed to prove consequential damages with sufficient certainty.

"[A] party may recover lost profits if (1) its alleged lost profits were caused by the breach; (2) the 'damages

were fairly within the contemplation of the parties' when contracting; and (3) the damages can be proven with a reasonable certainty." *Merlite Indus., Inc. v. Valassis Inserts, Inc.*, 12 F.3d 373, 376 (2d Cir. 1993) (quoting *Kenford Co. v. County of Erie*, 67 N.Y.2d 257, 261, 502 N.Y.S.2d 131, 132 (1986)).

The jury's award of consequential damages was supported by the evidence and was not contrary to law. First, RBC presented evidence at trial for the jury to reasonably conclude that RBC's lost profits were caused by defendants' breach. Such evidence included taped telephone conversations between personnel for RBC and Fidelity, as well as testimony from RBC's Parent and Highland's Mark Okada, which indicated that Fidelity and Highland ceased doing business with RBC as a result of RBC's failure to deliver defendants' Notes. Second, RBC presented evidence for the jury reasonably to conclude that lost profits were within the contemplation of the parties when the agreement was made. RBC presented evidence, such as taped telephone conversations and testimony regarding Rauch's experience in the industry, from which the jury could reasonably conclude that Rauch, acting as defendants' agent, knew RBC would be selling defendants' Notes to a third party and that such lost profits were a foreseeable consequence of defendants' breach. Third, the jury could rationally conclude that RBC proved lost profits damages with reasonable certainty. Expert witness Guild testified extensively on this topic and discussed his calculation of lost profits based on transactions between RBC and Fidelity, and RBC and

Highland. Thus, the jury's award of consequential damages for lost profits was not contrary to law, was supported by evidence, and is not grounds for a new trial.

e. *RBC-Rauch Settlement*

RBC filed a National Association of Securities Dealers, Inc. ("NASD") arbitration Statement of Claim against GRS in March 2003, asserting claims arising out of the role of GRS and Rauch in selling defendants' Notes to RBC. RBC and GRS settled the dispute prior to an arbitration hearing being held. Prior to trial, defendants moved to compel production of the settlement agreement. Magistrate Judge Gorenstein denied that request under Federal Rule of Civil Procedure 26(b)(1), in an Order dated September 28, 2007, indicating that consideration of the request, as it relates to any reduction in RBC's damages, would be more appropriate following trial. *See Highland Capital Mgmt., L.P. v. Schneider et al.*, No. 02 Civ. 8098, slip op. at 3 (S.D.N.Y. Sept. 28, 2007) (Gorenstein, M.J.). RBC filed a motion *in limine* to exclude defendants from offering any evidence, testimony, argument, or reference at trial regarding the NASD arbitration or the settlement with GRS. The Court granted RBC's motion and defendants were precluded from offering evidence, testimony, argument, or reference to the arbitration and subsequent settlement.

Now, defendants ask the Court to direct RBC "to produce the settlement agreement or disclose the

amount of the settlement, and the amount paid by Rauch must be subtracted from RBC's judgment. . . ." (Defs.' Memo. of Law at 49.) In opposition, RBC argues that because this issue was not raised by defendants at trial, it is improperly raised in defendants' post-trial motion. (RBC Opp. at 42 n.21.) RBC's assertion is unfounded. Defendants repeatedly raised the arbitration and settlement issue before trial. In his Order, Magistrate Judge Gorenstein stated that "[c]ases considering such an argument have typically determined that the settlement amount should be disclosed only following trial, and we follow that same approach here." *Highland Capital Mgmt.*, slip op. at 3. Therefore, the Court must consider whether RBC should be directed to produce the settlement agreement or amount and whether to subtract that amount from RBC's judgment.

Defendants fail to provide any legal support for their assertion that "the damages awarded to RBC must be reduced by the amount of the GRS-RBC settlement." (Defs.' Reply at 19.) Courts have noted that section 15-108 of New York's General Obligations Law ("GOL") may permit disclosure, after trial, to a non-settling defendant of a settlement amount between plaintiff and a settling party. *See ABF Capital Mgmt. v. Askin Capital*, No. 96 Civ. 2978, 2000 WL 191698, at *3 (S.D.N.Y. Feb. 10, 2000). Section 15-108, however, applies only in tort actions. *See, e.g., Bauman v. Garfinkle*, 235 A.D.2d 245, 245, 652 N.Y.S.2d 32, 33 (1st Dep't 1997) (citing *Bankers Trust Co. v. Lee Keeling & Assocs. Inc.*, 20 F.3d 1092, 1099 (10th Cir. 1994) (applying New York law)). At trial, plaintiffs only asserted contract claims. Accordingly, section 15-108 does not apply here.

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GRS and Rauch were never parties in this action. The jury found that defendants were liable to plaintiffs for certain damages. Although Rauch acted as defendants' agent, his own liability was never before the jury and there was no finding that he breached any obligation to plaintiffs on his own behalf. Further, Magistrate Judge Gorenstein, after reviewing the settlement agreement *in camera*, stated that it includes "no admissions of liability or any other material relating to the merits of the dispute." *Highland Capital Mgmt.*, slip op. at 3. The settlement between RBC and GRS is separate from the jury's award and has no bearing on RBC's damages in this action. Defendants' request to have the Court direct RBC to disclose the settlement agreement or amount is denied.

2. *Substantial Errors Arguments*

Defendants also assert that the Court committed substantial errors which require the Court to grant a new trial. Defendants take issue with the jury charge, the verdict form, and certain evidentiary rulings. (Defs.' Memo. of Law at 50.)

a. *Jury Charge*

Defendants contend that a new trial is required because the Court failed to instruct the jury properly on the law regarding oral agreements. Specially, defendants argue that the Court's instructions were improper on the following subjects: plaintiffs' burden to prove the existence of a binding oral agreement;

defendants' intent to be bound absent a writing; the instruction that "an oral agreement for the sale of securities is binding and enforceable under New York law" made the charge confusing and incorrect; and the Court provided little guidance on the factors for the jury to consider whether there was a binding oral agreement.

The Court properly instructed the jury that plaintiffs "must show that there was a meeting of the minds between Rauch and RBC on the essential terms of the contract, demonstrating mutual assent and a mutual intent to be bound." (Jury Charge at 40, 45.) Because it is the law of the case that the Notes at issue are securities, *Highland Capital Mgmt., L.P. v. Schneider*, 8 N.Y.3d 406, 834 N.Y.S.2d 692, 866 N.E.2d 1020 (2007), the Court properly instructed the jury regarding oral agreements for the sale of securities. The Court adequately instructed the jury regarding whether a party intends to be bound absent a writing by stating that "if the parties contemplate a formal written contract and that they will not be bound until such contract is signed, there is no binding agreement absent such contract." (Jury Charge at 40-41.) Although the Court did not enumerate the four *Winston* factors in the instructions on breach of contract, but did so in the instructions on breach of a preliminary agreement, the instructions, taken as a whole, properly instructed the jury on how to determine whether an oral agreement had been reached. Further, there was no indication that the jury was confused by the instructions; the jury's only note during deliberations was a request for a copy of the entire jury charge. In sum, the Court's

instructions were neither unclear nor incorrect as a matter of law. [4]

b. *Verdict Form*

Defendants argue that the verdict form was deficient, asserting that it was "doomed to confuse the jury" because the form did not ask the jury to decide whether each defendant had entered into a binding agreement to sell Notes. The verdict form asked the jury: "Do you find that plaintiff RBC is entitled to recover damages from defendants for breach of contract?" The form then listed each of the defendants by name and provided a space for the jury to check "yes" or "no". Similar language and a similar format were used with respect to Highland's claim as well.

The jury was provided the verdict form only after the Court's extensive instructions. The Jury Charge and the verdict form required the jury to consider numerous hurdles, including whether each defendant had entered into a binding agreement, whether each defendant had breached that agreement, and whether plaintiffs were

4. Defendants also argue that the jury charge was erroneous because it declined to include defendants' proposed language regarding objective manifestation of the parties' intent to be bound to a contract. (Defs.' Memo. of Law at 62.) The Court's instruction that RBC was required to prove that the parties had "a meeting of the minds" on essential terms and demonstrated "mutual assent and mutual intent to be bound" was a proper recitation of the law and was not substantial error. (Jury Charge at 40, 45.)

entitled to recover damages for that breach. There was no indication that the jury was confused by the instructions or the verdict form. The Court properly exercised its discretion in choosing the wording of the verdict form. The verdict form was sufficient; therefore defendants' argument does not support granting a new trial.

c. *Admission of Evidence*

At trial, the jury heard recordings of numerous telephone calls, which had been recorded by RBC in its regular course of business. There were conversations between RBC employees and Rauch, RBC employees and Highland employees, RBC employees and Fidelity employees, and among RBC employees. Prior to trial, defendants sought a ruling excluding all taped conversations between Highland and RBC, between Fidelity and RBC, and amongst RBC employees (hereinafter referred to as the "non-Rauch recordings"). Defendants argued that whatever RBC personnel told a fellow employee, Highland, or Fidelity was not relevant or attributable to defendants. The Court denied that motion, without prejudice for renewal at trial. However, the Court stated that, generally, the non-Rauch recordings were relevant under Federal Rule of Evidence 401. At various times during the trial when non-Rauch recordings were played for the jury, the Court issued a limiting instruction.

Defendants now argue that a new trial is warranted because the Court committed substantial error in

admitting the non-Rauch recordings, which they assert were irrelevant hearsay. Defendants argue that the Court's *in limine* ruling was erroneous, that the state of mind exception to the hearsay rule did not apply here, and that the Court's limiting instruction did not cure the prejudice that defendants suffered. In order to warrant a new trial, the introduction of inadmissible evidence must have been a clear abuse of discretion and so clearly prejudicial to the outcome of the trial that the result was seriously erroneous or a miscarriage of justice. *See SR Int'l Bus. Ins. Co., Ltd. v. World Trade Ctr. Props., LLC*, 467 F.3d 107, 119 (2d Cir. 2006); *Nimely v. City of New York*, 414 F.3d 381, 399-400 (2d Cir. 2005); *Perry v. Ethan Allen, Inc.*, 115 F.3d 143, 150 (2d Cir. 1997).[5]

As the Court stated in its *in limine* decision and numerous times at trial, the non-Rauch recordings were not admissible for the truth of the matter asserted, but rather, were admissible "only insofar as it may reflect on the state of mind of either the speaker or the

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5. Defendants also assert that plaintiffs' counsels' use of the phrase "material nonpublic information" forty-five times during the trial was unfairly prejudicial to defendants. (Defs.' Memo. of Law at 61 n.21; Defs.' Reply at 44.) The Court refers to its *in limine* ruling, which adequately addressed defendants' concerns about prejudice from being unfairly portrayed as "bad people" by substantially limiting the language that could be used. *See Highland Capital Mgmt.*, 551 F. Supp. 2d at 191-93. The Court properly allowed plaintiffs to use the phrase "material nonpublic information" and defendants were not unfairly prejudiced by plaintiffs' use of it.

listener." (Trial Tr. at 137:25-138:2.) Federal Rule of Evidence 803(3) states:

> Then existing mental, emotional, or physical condition. A statement of the declarant's then existing state of mind, emotion, sensation, or physical condition (such as intent, plan, motive, design, mental feeling, pain, and bodily health), but not including a statement of memory or belief to prove the fact remembered or believed unless it relates to the execution, revocation, identification, or terms of declarant's will.

Here, the non-Rauch recordings include statements "of the declarant's then existing state of mind," *id.*, regarding the sale of defendants' Notes. The recordings occurred while the negotiations were proceeding, thus capturing the speakers' state of mind during the relevant period.[6]

Additionally, the non-Rauch recordings were relevant. "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more or less probable than it would be without the evidence."

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6. Highland contends that the non-Rauch recordings are not hearsay because they are business records under Federal Rule of Evidence 803(6). (Highland Opp. at 37.) As the Court stated at trial, however, even if the recordings could be considered business records, there still could be a hearsay-within-hearsay problem rendering them inadmissible.

Fed. R. Evid. 401. Although the non-Rauch recordings were not direct evidence of whether defendants agreed to sell their Notes, (Defs.' Reply at 41), the recordings were relevant to plaintiffs' claims under the Rule 401 standard. The recordings reflected the state of mind of the key personnel in the negotiations in the moments leading up to and following the transaction that gave rise to this action.

Under *Federal Rule of Evidence 403*, relevant evidence may be excluded where "its probative value is substantially outweighed by the danger of unfair prejudice." Evidence is prejudicial under *Rule 403* if it "involves 'some adverse effect . . . beyond tending to prove the fact or issue that justified its admission into evidence.'" *United States v. Gelzer*, 50 F.3d 1133, 1139 (2d Cir. 1995) (quoting *United States v. Figueroa*, 618 F.2d 934, 943 (2d Cir. 1980)). Such evidence will be excluded if it has "an undue tendency to suggest decision on an improper basis, commonly, though not necessarily, an emotional one." Fed. R. Evid. 403, advisory committee's notes. Here, the probative value of the non-Rauch recordings substantially outweighed any danger of unfair prejudice to defendants. The evidence was relevant and useful to the jury in understanding the circumstances of the transaction, as well as plaintiffs' state of mind at the time of the transaction. This is particularly so where the recordings were made at the time of the transaction and the trial did not occur until seven years later.

As previously noted, during the trial, the Court issued a limiting instruction to the jury regarding

evidence admitted under the state of mind exception to the hearsay rule, stating that it may only be considered as evidence of the state of mind of the speaker or listener. In addition to repeating the instruction at appropriate times during the trial, the Court included the limiting instruction in its Jury Charge. During the testimony of the first witness in which the issue arose, the Court informed the jury that defendants' counsel "has a standing objection with respect to the testimony of this witness, and he may well renew it with respect to others." (Trial Tr. at 137:16-18.) There is a presumption that a jury follows such limiting instructions. *See United States v. Downing*, 297 F.3d 52, 59 (2d Cir. 2002) ("Absent evidence to the contrary, we must presume that juries understand and abide by a district court's limiting instructions.") (citing *Zafiro v. United States*, 506 U.S. 534, 540-41, (1993)). The instruction cured any potential unfair prejudice that defendants might have suffered.

d. *Holmes*

Defendants sought to make reference to Judge Cabranes's 1991 opinion in *S.N. Phelps & Co. v. Prudential Insurance Co.*, No. 91 Civ. 00451 (D. Conn. 1991), a case which involved RBC's Max Holmes and his previous employer, Prudential Insurance Co. Defendants intended to ask questions of Holmes regarding his involvement in and understanding of that action, believing it had some bearing on his intent in drafting the January 5, 2001 Letter Agreement in this case. The Court excluded any reference to *Phelps* at trial.

Defendants now assert that the Court's exclusion of such evidence was in error and that a new trial is warranted. The Court, however, properly excluded evidence relating to *Phelps*. Judge Cabranes's *Phelps* decision was inadmissible hearsay. *See Blue Cross and Blue Shield of New Jersey, Inc. v. Philip Morris, Inc.*, 141 F. Supp. 2d 320, 323 (E.D.N.Y. 2001) ("Judicial findings in other cases proffered as evidence are generally characterized as inadmissable hearsay."); *cf. Torah Soft Ltd. v. Drosnin*, No. 00 Civ. 0676, 2003 WL 22024074, at *1-2 (S.D.N.Y. Aug. 28, 2003) (holding that where a prior judicial opinion in a related action may have preclusive effects, the opinion may be admissible evidence). Even if such evidence could fall under a hearsay exception, an opinion from another jurisdiction, in a case between different parties, from many years prior, and when the witness was with a different employer, was not relevant in this action under Federal Rule of Evidence 401. Furthermore, under the Federal Rule of Evidence 403 balancing test, any reference to *Phelps* would have been substantially more prejudicial than probative. The risk of unfair prejudice was high because the jury may have given undue weight to any reference by defendants to *Phelps* or Holmes's involvement in *Phelps*. Additionally, reference to *Phelps* in any way was likely to cause juror confusion. The Court also notes that defendants were granted the opportunity to cross-examine Holmes and thereby challenge his credibility and inquire as to his intent in drafting the Letter Agreement. Even if the Court's ruling was error, it certainly was not substantial error warranting a new trial. Accordingly, the Court rejects defendants' argument that a new trial is warranted on this basis.

Appendix B

e. *Guild*

Guild testified as an expert witness for plaintiffs. Defendants now assert that the Court's admission of Guild's testimony on custom and practice in the securities industry was material error. The Court ruled on the admissibility of Guild's testimony in its January 31, 2008 decision on the parties' numerous motions *in limine*. *See Highland Capital Mgmt.*, 551 F. Supp. 2d at 182-83. The Court held that Guild was qualified to testify as an expert and permitted him to testify on industry custom and practice, finding it relevant to the case and potentially helpful to the jury. The Court did place limits on Guild's testimony, ruling that he could not testify regarding an individual's state of mind or credibility, and that he could not testify as to ultimate legal conclusions. *Id.*

The admission of industry custom and practice testimony in a securities action is not uncommon. *See, e.g., United States v. Bilzerian*, 926 F.2d 1285, 1294 (2d Cir. 1991) ("Particularly in complex cases involving the securities industry, expert testimony may help a jury understand unfamiliar terms and concepts."); *S.E.C. v. Lorin*, 877 F. Supp. 192, 196 (S.D.N.Y. 1995), *modified*, 76 F.3d 458 (2d Cir. 1996); *Marx & Co., Inc. v. Diners' Club, Inc.*, 550 F.2d 505, 511 (2d Cir. 1977), *cert. denied*, 434 U.S. 861 (1977). Although defendants' Notes were "unusual" and their sale was not like a typical public security trade, industry custom and practice has proven relevant to this case as it progressed through this Court, the Second Circuit, and the New York Court of Appeals.

As in other cases involving securities, such testimony aided the jury in understanding the issues before them.

Guided by the Court's *in limine* decision, Guild limited his testimony and did not draw legal conclusions. Rather, he testified regarding factors indicating to him, as an expert, whether there was an oral agreement and whether Rauch was defendants' agent. *See* In re *Blech Secs. Litig.*, No. 94 Civ. 7696, 2003 WL 1610775, at *22-23 (S.D.N.Y. Mar. 26, 2003) (Sweet, J.). Additionally, defendants' assertion that Guild's industry custom and practice testimony should not have been permitted because defendants themselves were not members of the security industry is unfounded. The jury concluded that Rauch, a broker in the securities industry, was acting as defendants' agent in the sale of these securities. Defendants also were granted the opportunity to present their own expert witness on these same issues, with the same limitations. Finally, the Court instructed the jury regarding the role of expert testimony. (*See, e.g.*, Trial Tr. at 610:9-612:23.)

f. *Actual and Apparent Authority*

Defendants assert that the Court's instructions on actual and apparent authority were erroneous and warrant a new trial. Defendants contend that the Court erred by instructing the jury on actual authority, claiming that there was no evidence of it at trial. They also argue that the Court erred in including an instruction on implied actual authority, and that the erroneously included instruction was incomplete.

Additionally, defendants claim that the Court's instructions on apparent authority were misstated and gave the jury a false impression of Rauch's authority. Finally, defendants argue that the Court failed to explain that the jury needed to find two levels of agency for the claims against Susan, Leslie, and Scott.

The Court's charge on actual and apparent authority was consistent with New York law and, as a whole, adequately instructed the jury on the law. Plaintiffs presented some evidence that Rauch possessed actual authority to bind defendants to a sale of their Notes; therefore, an instruction on actual authority was appropriate. *See, e.g., Hilord Chem. Corp. v. Ricoh Elecs., Inc.*, 875 F.2d 32, 38 (2d Cir. 1989) ("All that is necessary is that there be some evidence supporting a party's theory of the case.") (citing *Doyle v. Exxon Corp.*, 592 F.2d 44, 47 (2d Cir. 1979)). Further, the Court's instruction that "[i]f an agent has implied actual authority, the agent is authorized to act in a manner in which the act is ordinarily performed or which is inherent or incidental to the ordinary scope of authority associated with the agent's position, unless the principal informs the third party of a specific limitation on the agent's authority," (Jury Charge at 35), was an adequate statement of the law.

In addition, the Court's instruction on apparent authority was not erroneous. The Court properly exercised its discretion in denying defendants' request to include additional language regarding apparent authority in this particular case. The Court did not

convey to the jury any false impressions, as defendants' claim, but instead, allowed the jury to perform its fact-finding role.

Contrary to defendants' assertion, the Court did instruct the jury regarding whether Rauch was an agent for each defendant and whether Leonard was an agent for Leslie, Susan, or Scott. Indeed, the Court instructed the jury that they "should apply these [agency] principals to the facts of this case in determining whether or not Glen Rauch was an agent of the Schneiders with the authority to sell the notes at issue, or whether or not Leonard Schneider was an agent of his children with the authority to hire and direct Rauch to negotiate and sell on behalf of the Schneiders." (Jury Charge at 33.) This instruction, taken together with the rest of the charge, was not confusing or misleading.

In sum, the jury's findings were well supported by the evidence at trial, and the Court did not commit substantial errors warranting a new trial. The Court cannot say that the jury's verdict is against the weight of the evidence or that the jury reached a seriously erroneous result. Therefore, defendant's motion for a new trial is denied.

II. *Amendment of the Judgment*

All parties request that the Court amend the Judgment. Plaintiffs bring a joint motion to correct the judgment pursuant to Rule 60(a) of the Federal Rules of Civil Procedure and defendants bring a motion to alter or amend the judgment pursuant to Rule 59(e) of the

Federal Rules of Civil Procedure. For the following reasons, plaintiffs' motion is granted and defendants' motion is denied.

A. *Federal Rules of Civil Procedure 59(e) and 60(a)*

Federal Rule of Civil Procedure 59(e) provides that "[a] motion to alter or amend a judgment must be filed no later than 10 days after the entry of the judgment." A motion to amend a judgment pursuant to Rule 59(e) properly is granted where the movant demonstrates that the judgment is based upon manifest errors of law or fact. *See, e.g., Davidcraft Corp. v. Danu Int'l, Inc.*, No. 90 Civ. 6578, 1992 WL 247035, at *1 (S.D.N.Y. Sept. 15, 1992); *Wallace v. Brown*, 485 F. Supp. 77, 79 (S.D.N.Y. 1979).

Federal Rule of Civil Procedure 60(a) provides that "[t]he court may correct a clerical mistake or a mistake arising from oversight or omission whenever one is found in a judgment, order, or other part of the record. The court may do so on motion or on its own, with or without notice." The "general purpose of Rule 60(a) 'is to afford courts a means of modifying their judgments in order to ensure that the record reflects the actual intentions of the court.'" *Slupinski v. First Unum Life Ins. Co.*, No. 99 Civ. 0616, 2006 WL 2266569, at *2 (S.D.N.Y. Aug. 7, 2006) (quoting *Employers Mut. Casualty Co. v. Key Pharms.*, 886 F. Supp. 360, 363 (S.D.N.Y. 1995)). Thus, Rule 60(a) "permits the correction not only of clerical mistakes, but also of inadvertent errors arising from oversight or omission." In re *Marc Rich & Co. A.G.*, 739 F.2d 834, 836 (2d Cir. 1984) (internal quotations omitted).

Appendix B

B. *Damages Awards*

1. *General Damages*

The parties agree that the Judgment should be amended to reflect that defendants' liability for general damages should have been several, and not joint. (Pls.' Amend. Memo. of Law at 3; Defs.' Amend. Opp. at 3.) The parties also agree to the apportionment of general damages to each defendant based on the amount of his or her notes. (Defs.' Amend. Opp. at 10-11.) However, the parties disagree as to whether the amendment should be made pursuant to Rule 59(e) or Rule 60(a).

The Court holds that because an amendment of the general damages here involves correction of only "clerical mistakes" or "inadvertent errors," In re *Marc Rich & Co. A.G.*, 739 F.2d at 836, and not "manifest errors of law or fact," *Bowers v. Andrew Weir Shipping, Ltd.*, 817 F. Supp. 4, 5 (S.D.N.Y. 1993) (Leisure, J.), the Court shall amend the Judgment pursuant to Rule 60(a). The amendment "is a type of mistake or omission mechanical in nature which is apparent on the record and which does not involve a legal decision or judgment by an attorney." *Hegger v. Green*, 91 F.R.D. 595, 597 (S.D.N.Y. 1981) (internal quotations omitted). Here, the intent of the Court was clear.[7] *See Robert Lewis Rosen Assocs., Ltd. v. Webb*, 473 F.3d 498, 503-04 (2d Cir. 2007).

7. The jury's benefit of the bargain damages award was based on the face value of defendants' eight promissory notes less the amount plaintiffs would have paid for the notes, plus interim interest. (Pls.' Memo. of Law at 3-4.) The jury's award plainly was based on each defendant's breach with respect to his or her individual notes.

Accordingly, the Judgment shall be amended to indicate that defendants are severally liable for general damages in the following amounts. Highland is awarded damages of $3,173,974.33 from Leonard, $13,155,659.68 from Leslie, $13,155,659.68 from Susan, and $6,571,030.05 from Scott. RBC is awarded damages of $19,411,278.21 from Leonard, $368,828.32 from Leslie, $368,828.32 from Susan, and $199,414.16 from Scott.

2. *Consequential Damages*

The jury awarded $5 million in consequential damages to RBC. With pre-judgment interest of $3,027,945.20, defendants are jointly liable for $8,027,945.20 in consequential damages to RBC under the Judgment. The parties dispute whether defendants should be jointly liable for the consequential damages. Defendants assert that, if the Court deems the Judgment correctable,[8] only Leonard should be liable for consequential damages because most or all of the consequential damages award was based on lost business from Fidelity.[9] (Defs.' Amend. Opp. at 12-13.) Defendants assert that "[t]he most reasonable way to amend the judgment would be to attribute the consequential damages to the source of what is very

8. Defendants' primary argument is that there is an insufficient basis for awarding consequential damages; however, in light of the Court's decision above denying defendants' motion for judgment as a matter of law, or in the alternative, for a new trial, the Court considers defendants' secondary argument here.

9. Leonard's breach of his obligation to deliver his $23.6 million promissory note was the source of RBC's lost business damages from Fidelity. (Defs.' Amend. Opp. at 5.)

probably over 98% of them, by making only Leonard Schneider individually liable for those damages." (Defs.' Amend. Reply at 5.) RBC contends that defendants should be jointly liable for consequential damages because RBC put forth evidence of lost business profits from both Fidelity and Highland, and defendants have failed to show why the lost business damages should be attributed only to Leonard. (RBC's Amend. Reply at 3-4.)

The parties' dispute focuses on the question of whether the jury's award of consequential damages included lost business solely from Fidelity or from Highland as well. As defendants admit, "[i]t is impossible to answer this question with certainty. . . ." (Defs.' Amend. Reply at 4-5.) Defendants further acknowledge that "the jury's consequential damages award cannot be parsed with precision." (*Id.* at 5.) The jury did not adopt the consequential damages figures set forth by RBC during the trial.[10] Defendants have failed to demonstrate that the jury's actual intentions were not reflected in the Judgment. *See Employers Mut. Casualty Co.*, 886 F. Supp. at 363. Thus, the Court finds no basis for disturbing the consequential damages award in the Judgment.

3. *Post-Judgment Interest*

Under *28 U.S.C. § 1961(a)*, "interest shall be calculated from the date of the entry of the judgment, at a rate equal to the weekly average 1-year constant

10. RBC sought $6,766,992.50 for consequential damages. They claimed lost profits of $6,643,968.75 from business with Fidelity, and $123,023.75 from business with Highland. (Defs.' Reply at 3.)

maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System, for the calendar week preceding the date of the judgment." The parties agree that post-judgment interest should begin to run from March 11, 2008, which was the date of entry of judgment. (Highland's Amend. Reply at 4; Defs.' Amend. Opp. at 13-14.) Plaintiffs assert, and defendants do not dispute, that the applicable post-judgment interest rate should be 1.66%. (McNamara Aff. Ex. 11 (Federal Reserve Statistical Release, H.15(519) Selected Interest Rates (Mar. 10, 2008)).) Accordingly, the Judgment shall be amended to indicate that the post-judgment interest shall run from March 11, 2008 at a rate of 1.66%.

CONCLUSION

For the reasons set forth above, defendants' motion for judgment as a matter of law, or in the alternative, for a new trial is hereby DENIED. Plaintiffs' joint motion to correct the judgment is hereby GRANTED, and defendants' motion to alter or amend the judgment is hereby DENIED.

SO ORDERED.

New York, New York
August 20, 2008

/s/ Peter K. Leisure
U.S.D.J.

APPENDIX C — DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT FILED AUGUST 23, 2010

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 23rd day of August, two thousand ten.

Highland Capital Management LP,

Plaintiff-Appellee,

RBC Dominion Securities Corp.,

Third-Party-Defendant-
Counter-Claimant-Appellee,

v.

Leonard Schneider, Leslie Schneider,
Scott Schneider, Susan Schneider,

Defendants-Third-Party-Plaintiffs-
Counter-Defendants-Appellants,

Jenkins & Gilchrist Parker Chapin LLP,

Defendant.

Appendix C

RBC Dominion Securities Corp. having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the active members of the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe, Clerk
/s/ Catherine O'Hagan Wolfe

APPENDIX D — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DECIDED JULY 25, 2005 FILED JULY 26, 2005

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

02 Civ. 8098 (PKL)

2005 U.S. Dist. LEXIS 14912

HIGHLAND CAPITAL MANAGEMENT, L.P.,

Plaintiff,

- against -

LEONARD SCHNEIDER, LESLIE SCHNEIDER, SCOTT SCHNEIDER, SUSAN SCHNEIDER and JENKENS & GILCHRIST PARKER CHAPIN L.L.P.,

Defendants.

LEONARD SCHNEIDER, LESLIE SCHNEIDER, SCOTT SCHNEIDER, and SUSAN SCHNEIDER,

Third-Party Plaintiffs,

- against -

RBC CAPITAL MARKETS CORPORATION f/k/a/ RBC DOMINION SECURITIES CORPORATION,

Third-Party Defendant and Third-Party Counterclaimant.

Appendix D

July 25, 2005, Decided
July 26, 2005, Filed

OPINION

OPINION AND ORDER

JUDGE: Peter K. Leisure, U.S.D.J.

Plaintiff, Highland Capital Management L.P. ("Highland"), brings this action to recover in tort and contract from the defendants, Leonard, Leslie, Scott, and Susan Schneider ("the Schneiders") for their refusal to sell certain promissory notes, valued at $ 69 million, to plaintiff Highland and third-party defendant / counterclaimant, RBC Capital Markets Corporation, formerly known as RBC Dominion Securities Corporation ("RBC"). RBC intended to act as a "riskless principal," purchasing the notes from the Schneiders and immediately selling them to Highland and others at a premium. Plaintiff alleges that the Schneiders refused to sell after defendants Jenkens & Gilchrist Parker Chapin L.L.P. ("JGPC") supplied them with insider information that the notes would be paid in full following a merger deal involving the issuer of the notes, McNaughton Apparel Group, Inc., formerly known as Norton McNaughton, Inc. ("McNaughton") and Jones Apparel Group ("Jones"). Plaintiff thus sues for breach of contract under various theories, and tortious interference with contract and prospective business relations. The Schneiders' answer asserts claims against RBC for breach of various duties, breach of contract,

breach of the implied covenant of good faith and fair dealing, and negligence, ultimately seeking indemnification and/or contribution. RBC's answer asserts counter-claims against the Schneiders for breach of the duty to negotiate, breach of the covenant of good faith and fair dealing, breach of contract, fraudulent misrepresentation, and fraudulent concealment. Discovery is complete and defendants now move for summary judgment and for judgment on the pleadings to dismiss Highland and RBC's claims against them. RBC cross-moves for summary judgment to dismiss the Schneiders' claims against it. The Court disposes of the motions below, granting, in part, defendants' motion for summary judgment against plaintiff and dismissing the entire action for want of subject matter jurisdiction.

BACKGROUND[1]

I. The Parties

Plaintiff Highland is a limited partnership and registered investment advisor with its principle place

1. Unless otherwise noted, the following facts are not in dispute. The facts are drawn from the parties incredibly voluminous submissions to this Court on this motion, including pleadings, motion papers, supporting affidavits, declarations, exhibits, and the parties statements of fact pursuant to Local Rule 56.1. *See also Highland Capital Mgmt., L.P. v. Schneider*, No. 02 Civ. 8098, 2004 U.S. Dist. LEXIS 18131 (S.D.N.Y. Sept. 9, 2004) (granting plaintiff leave to amend the Complaint and detailing the factual history of the case). Further, pursuant to

(Cont'd)

of business in Dallas, Texas. (Plaintiff's Third Amended Complaint ("Complaint") P2.) Highland specializes in credit and special situation investing, managing over $ 9 billion dollars. (*Id.*)

Defendant Leonard Schneider is a Florida resident and the father of co-defendants Leslie, Susan, and Scott Schneider, all residents of New York State. The Schneiders were owners of two apparel businesses before selling them to McNaughton in return for stock and the promissory notes at issue here.

Defendant JGPC was a limited liability partnership engaged in the practice of law with its principle office in New York State. (*Id.* P7.)

Third-party defendant RBC is a registered broker-dealer with the Securities Exchange Commission ("SEC") and a member of the New York Stock Exchange ("NYSE"). (Defendants' 56.1 Statement ("Defs.' 56.1") P8 (unopposed).) RBC is a New York corporation with its principle place of business in New York. (*Id.* PP6-7 (unopposed).)

(Cont'd)

the Opinion and Order issued by Magistrate Judge Gabriel W. Gorenstein granting defendants' motion to exclude Highland's proposed expert witness, Sean F. O'Shea, dated July 19, 2005, the Court did not consider the O'Shea affidavit submitted to support the instant motion. The following does not constitute findings of fact by this Court.

Appendix D

II. Procedural History

Highland filed its original complaint against the Schneiders and RBC in Texas State Court on October 18, 2001. (Defendants' Memorandum of Law in Support of Motions for Summary Judgment ("Defs.' Mem.") Ex. 5.) On May 7, 2002, Highland and RBC entered into a tolling agreement wherein Highland and RBC agreed not to pursue claims against each other for two years from execution of the agreement or thirty days after disposition of Highland's case against the Schneiders. (Defs. Mem. Ex. 7.) Highland and RBC also agreed to cooperate to some extent in Highland's prosecution of claims against the Schneiders. On May 9, 2002, Highland submitted an amended complaint in Texas State Court which dropped RBC as a named defendant to the action. (Defs.' Mem. Ex. 164.) The case was removed to the United States District Court for the Northern District of Texas on September 27, 2002, and transferred to this Court on October 11, 2002.

After numerous amendments, the plaintiff's third amended complaint is the operative pleading for the present motion. In it, plaintiff asserts claims against the Schneiders for (1) breach of contract; (2) alternatively, breach of binding preliminary agreement; (3) alternatively, third-party beneficiary breach of contract; (4) alternatively, tortious interference with contract; and (5) alternatively, tortious interference with prospective contractual and business relations. (Compl. PP56-79, 98-103.) Plaintiff also asserts claims against JGPC for (1) tortious interference with contract; and (2) alternatively,

tortious interference with prospective contractual and business relations. (*Id.* PP80-97.) Plaintiff seeks actual, consequential, and punitive damages, prejudgment interest, attorney's fees and costs. (*Id.* at 35.)

On October 29, 2004, the Schneiders filed a third-party complaint against RBC. (Defendants' Answer and Third-Party Complaint ("Defs.' Ans.").) The Schneiders allege that, (1) RBC breached its duty as their alleged agent by exceeding its authority to bind its principal; (2) RBC breached its contract with the Schneiders; (3) RBC breached the implied covenant of good faith and fair dealing; and, (4) RBC was negligent in performing its duties as a registered broker-dealer. (Defs.' Ans. PP89-128.) The Schneiders seek indemnity, or alternatively, contribution if they are found liable to Highland for RBC's actions. (*Id.*)

RBC answered the third-party complaint on November 19, 2004, and asserted counterclaims against the Schneiders for (1) breach of the duty to negotiate; (2) breach of contract; (3) fraudulent misrepresentation; (4) fraudulent concealment; and, (5) breach of the covenant of good faith and fair dealing. (RBC's Counterclaims and Answer to the Third-Party Complaint ("RBC 3d Party Compl.") PP134-72.) RBC requests actual, compensatory and punitive damages, along with prejudgment interest. (*Id.* at 26-27.) Further, on May 3, 2004, RBC received an assignment of Fidelity Management and Research Company's ("Fidelity") potential claims pursuant to the note purchase

transaction at issue.[2] (RBC's 56.1 Statement ("RBC 56.1") P115.)

On April 21, 2005, Troutman Sanders L.L.P. was substituted as counsel for defendants. Previously, JGPC represented all defendants, however JGPC is no longer doing business as a law firm. The attorneys representing defendants joined Troutman Sanders following JGPC's demise, therefore, defendants' attorneys have not changed, only the firm.

III. The Promissory Notes

The Schneiders owned and operated two clothing apparel businesses, Jeri-Jo Knitwear, Inc. and Jamie Scott, Inc. (collectively "Jeri-Jo") until April 15, 1998, when the businesses were sold to a McNaughton subsidiary. Prior to the sale, Jeri-Jo was a privately owned and closely held company. Leonard Schneider left Jeri-Jo after its sale, but the Schneider children stayed on as executives, reporting directly to Peter Bonepart, McNaughton's President and Chief Executive Officer ("CEO").

The sale agreement allotted each of the Schneiders a share of the purchase price in accordance with their ownership proportion. The sale required an initial payment of $ 55 million, the assumption of $ 10.9 million in Jeri-Jo debt, plus an earn-out based on the new Jeri-

2. Fidelity was a potential purchaser in the same posture as Highland, wishing to purchase the Schneider's notes from RBC at a slight premium following the sale to RBC. (RBC 56.1 P70.)

Jo's next two years of profits, ending June 30, 2000. At the end of the two year period, McNaughton had the option of paying the earn-out in cash or in up to 50% of its common stock. On June 30, 2002, the Schneiders were owed approximately $ 190 million in earn-out profits. The parties negotiated and reached two amendments to the purchase agreement on August 3, 2000 and August 29, 2000. The amendments fixed the earn-out at $ 161 million and each Schneider received, in proportion to their original Jeri-Jo ownership interest, (1) $ 95 million in cash on August 29, 2000; (2) an additional $ 30 million in cash on the closing date of McNaughton's new financing; (3) $ 26 million in McNaughton common stock; and (3) $ 10 million in four, three-year promissory notes.[3]

In the event that McNaughton could not make the $ 30 million payment or did not close its new financing deal, the money was to be issued as four additional three-year promissory notes, with a total face value of $ 59 million. The deadline for the $ 30 million payment was November 30, 2000. As the deadline approached, McNaughton requested an extension of time to pay until April 2001. In support of its request, on November 6, 2000, McNaughton's Chief Financial Officer ("CFO") Amanda Bokman, forwarded to the Schneiders, what Highland terms "very detailed, highly sensitive, confidential financial forecasts" for McNaughton,

3. This first set of promissory notes was issued August 29, 2000. Leonard Schneider received a note with a face value of $ 4 million, Susan and Leslie Schneider each received notes with face values of $ 2.4 million, and Scott Schneider received a note with a face value of $ 1.2 million.

intimating the proposed $ 59 million notes would pay out at most $ 30 million over three-years so the Schneiders should accept the more immediate $ 30 million payment in April 2001. (Pl.'s Opp'n at 8-9.) Plaintiff contends this constituted material inside information. (*Id.* at 9.) The Schneiders declined McNaughton's request and four new three-year promissory notes were issued, with a total face value of $ 59 million.[4]

The eight notes had a total face value of $ 69 million and were not payable to a generic bearer, but were made payable to the individual Schneiders. McNaughton was designated as the maker of these notes. Plaintiff characterizes these notes as "convertible subordinated debenture[*s]." (Plaintiff's Memorandum of Law in Opposition to Defendants' Motion for Summary Judgment ("Pl.'s Opp'n") at 4-5.) Plaintiff proffers this legal conclusion because the notes were subordinate to senior creditors and were convertible to stock if McNaughton were to dissolve. (*Id.* at 6; Exs. 152-55, § 5.2.) Dissolution also granted the Schneiders the option of accelerating the principle due on the notes. (*Id.*) The notes on their face are denominated "subordinated promissory notes." (*Id.* at 1.) The notes were subject to GAAP record-keeping requirements (*Id.* § 8(c)) and are governed by New York State law (*Id.* § 10).

4. This second set of promissory notes was issued on December 1, 2000. Leonard Schneider received a note with a face value of $ 23.6 million, Susan and Leslie Schneider received one note each with face values of $ 14,160,000, and Scott Schneider received a note with a face value of $ 7,080,000.

Appendix D

IV. Alleged Sale of the Notes

On November 7, 2000, the day after receiving McNaughton's financial forecast, Leonard Schneider sent a copy of one of the first set of promissory notes to Glen Rauch of Glen Rauch Securities, Inc. (collectively "GRS") via facsimile. The Schneiders and GRS had a twenty year history during which the Schneiders purchased municipal bonds worth millions of dollars.[5] On December 10, 2000, the Schneiders forwarded GRS a copy of the second set of notes. The Schneiders all represent that they were willing to entertain bids on the notes but maintain they would not sell the notes at a substantial discount. The notes were priced at between 40-65 cents on the dollar at this time.

On January 8, 2001, GRS entered into a Letter Agreement on behalf of the Schneiders with RBC. The Letter Agreement provided that RBC was a "possible purchaser" of some or all of the notes, and that the Schneiders, via GRS, would work with RBC exclusively for 30 business days regarding the possible sale. (Defs.' Mem. Ex. 24.) The Letter Agreement also specifically states that:

---

5. The parties here disagree as to the extent of the Schneider / GRS relationship. The Schneiders contend GRS was nothing more than a conduit through which they purchased municipal bonds. (Defs.' Mem. at 10 n.11.) Plaintiff's infer from Rauch and the Schneiders' deposition testimony that "Rauch was the Schneider family's long time broker and financial advisor, having handled nearly $ 100 million in numerous securities transactions for the [*sic*] each of the Schneiders for more than 20 years — all at the oral request of Leonard Schneider." (Pl.'s Opp'n at 10.)

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> Reference is made to certain promissory notes (the "Notes") issued by a public company in the apparel business, which are held by certain of your clients.
>
> We understand that Glen Rauch Securities, Inc. ("GRS") represents those holders in the possible resale of some or all of the Notes by those holders, for which GRS will be receiving separate compensation from those holders.
>
> Any possible resale of some or all of the Notes would be through an exemption from registration under the securities laws of the United States and other applicable jurisdictions. You [GRS] understand that any such transaction is subject to definitive documentation in compliance with applicable law. . . .
>
> We [RBC and GRS] both understand that the consummation of any transaction remains in the sole discretion and satisfaction of the holders and [RBC], including without limitation with respect to price.

(*Id.*)

Following this agreement, RBC began marketing the notes to third parties. On January 10, 2001, Kenneth Ambrecht, the RBC trader overseeing RBC's

involvement with the notes, called GRS to suggest that RBC contact McNaughton CEO Bonepart to advise him that RBC was investigating buying the notes.[6] However, in a letter from GRS to Ambrecht and another RBC employee, Max Holmes, states: "As per our conversation, this will confirm that any prospective buyers of the McNaughton Apparel notes will not contact the company directly. I understand you cannot control this completely, however if it does occur my clients will withdraw the deal. All questions or inquiries will be directed to Glen Rauch." (Pl.'s Ex. 50.) In a recorded telephone conversation on the same day, Rauch informed Ambrecht that the Schneiders' lawyer was "vehemently opposed" to any possible buyers contacting McNaughton, that the Schneiders would "pull the deal" and give it to someone else if contact occurred, and that GRS was to be the liaison for any questions potential buyers may have. (*Id.* Ex. 80C, RBC 896, 1.16.01.)[7]

---

6. RBC and Highland both assert that this conversation put GRS on notice that RBC was marketing the notes to third parties. However, a review of the tape recording of the conversation shows that Ambrecht merely stated that someone might contact McNaughton and Rauch responded, "one of your guys?" Ambrecht answered in the affirmative. (Pl.'s Opp'n Ex. 80C, RBC 895.) It is not clear to the Court whether "your guys" meant third party purchasers or RBC traders.

7. Plaintiff contends the letter, recorded conversation, and deposition testimony regarding RBC and Highland employees' understanding of their ability to contact the Schneiders evidence that potential buyers were also barred from contacting the Schneiders directly. (Pl.'s Opp'n 19.) A review of the evidence does not necessitate this conclusion, though it is not outside the realm of possibility.

Appendix D

On January 25, 2001, Rauch, Ambrecht, the Schneiders' attorney from JGPC, James Alterbaum, Esq., and Highland's attorney from Akin, Gump, Strauss, Hauer Feld LLP, Michael Kern, Esq., participated together in a conference call.[8] A Highland employee, Michael Rich, listened in silently because Highland wished to remain anonymous until they decided whether "to do anything." (Defs.' Reply Ex. 344, RBC 896, 1.25.14.) Prior to this call, the notes were referred to as "freely tradable securities" and "assignable." (Pl.'s Opp'n Ex. 78, RBC 896, 1.25.20.)

When the Letter Agreement's exclusivity clause expired on February 8, 2001, plaintiff contends that Rauch orally informed RBC that it was the only one working on the transaction and it should continue working. (Pl.'s Opp'n at 21.) During a telephone call on February 12, 2001, Ambrecht indicated to Rauch that an RBC employee had a potential buyer who would bid on the loans at 58 cents on the dollar if he had a firm offer.[9] Rauch gave Ambrecht a firm offer at 59 cents,

8. Defendants claim that neither Rauch nor Mr. Alterbaum knew that Mr. Kern was acting as Highland's attorney on the call. RBC admitted that Highland was to be kept anonymous in its response to defendants' Rule 56.1 statement. However, Ambrecht did mention to Mr. Alterbaum that lawyers for a potential purchaser of the promissory notes would be on the conference call, but did not mention Highland by name. (Pl.'s Opp'n Ex. 80C, RBC 896, 1.25.20.)

9. It is unclear whether Rauch knew at this time that the potential buyer was actually two buyers, Highland and Fidelity. Plaintiff points to a note, made by Rauch, titled "purchase of

(Cont'd)

with the caveat that he did not "know how you guys [RBC] are working it . . . you know the spread or whatever." (*Id.* Ex. 79, RBC 894, 2.12.02.) The negotiations continued with Ambrecht offering 51 1/2 cents on the dollar for only Leonard Schneider's $ 23.6 million note, alternatively, 47 cents on the dollar for all of the second set of notes, with a face value of $ 59 million.. Rauch countered on February 14, 2001, stating that if Ambrecht can get a letter of intent for the $ 23.6 million note, "I think we can do a trade." (*Id.* 2.14.14.)

On February 26, 2001, Rauch and Ambrecht again spoke about the status of a potential trade, with Ambrecht indicating he was waiting to hear back from his "guy," presumably a potential buyer of the McNaughton notes, and that the last bid he had was for 51 1/2. (*Id.* 2.26.05.) Rauch indicated he was 85% sure he could trade the "whole thing"[10] at 54 cents on the

(Cont'd)
the notes" and identifying Highland and Fidelity. (Pl.'s Ex. 23.) This note is undated but was produced in discovery on the same copy paper as a copy of a note dated February 12, 2001. The dated note is a message for Rauch, from Ambrecht, and contains the number range 58-63, followed by "offer 59." Relying on Rauch's deposition testimony, defendants contend that the two notes side by side appearance was merely an unfortunate coincidence of discovery production and does not evidence the date the Highland / Fidelity note was created. (Defs.' Reply at 15-16.)

10. It is unclear whether "the whole thing" represented both sets of notes, face value $ 69 million, or only the second set which had been the prime subject of negotiations up to this point, face value $ 59 million.

dollar but cautioned that he was dealing with individuals, intimating their unpredictability. (*Id.*) Ambrecht expressed frustration at not hearing back from a potential buyer and an unwillingness to push the buyer because of the state of the stock market. Later the same day, the pair spoke again. (*Id.* 2.26.08-09.) Ambrecht stated his "guy" had not moved, offering 51 1/2 for the $ 26.5 million note. (*Id.*) Rauch said the Schneiders would not trade at that price but if the bid was 54, he could do a trade on the $ 23.6 million and if the potential buyer wanted the "whole piece," he could do it for 53 cents on the dollar. (*Id.*) Rauch recounted a conversation he had with Leonard Schneider regarding the low bids wherein Rauch had told Leonard Schneider that, if RBC bids 54 cents on the dollar for his "piece," i. e. the $ 23.6 million note, RBC would own it, but anything lower and Leonard Schneider would "hold on for a while." (*Id.* 2.26.09-10.) Rauch stated that Leonard Schneider would consider a slightly lower bid for the rest of the notes if sold as a whole package.

The interaction between Rauch and Ambrecht caused RBC to intensify its negotiations with Highland and Fidelity.[11] On March 9, 2001, Ambrecht informed Rauch via telephone that he had one buyer giving a firm offer of 50 cents on the dollar for the entire $ 69 million piece,[12] and a second buyer offering 52 cents on the dollar for Leonard Schneider's $ 23.6 million note.[13] (Pl.'s Opp'n

11. In all recorded phone conversations with Rauch discussed in this section, Ambrecht refers to Highland and Fidelity generically as "guys" and never by their actual names.

12. Plaintiff maintains this buyer was Highland.

13. Plaintiff maintains this buyer was Fidelity.

Ex. 80C, RBC 795, 3.9.01.) Rauch stated he would prefer to trade all the notes at once, suggesting 50 1/2 cents on the dollar, and said he would call Leonard Schneider regarding the offers. As the parties neared a deal, RBC represented that Highland was anxious to close, as were Rauch and Ambrecht.

On March 12, 2001, a series of telephone calls were exchanged between Rauch and RBC. In the first of these calls, Rauch represented that Leonard Schneider was willing to sell his notes for 52 cents on the dollar, but that the rest of the family would not consider sale of their notes for another week or two because they were "not acting in concert, which they can't do." (Pl.'s Opp'n Ex. 80A, RBC 3.12.03.) Ambrecht cautioned that Highland might walk away from the deal if that were the case. Rauch then stated that the family would not put any guarantees or covenants on the notes if the bid were for 51 cents on the dollar but, rather, would sell them "as is." Ambrecht did not seem to understand the necessity of guarantees or covenants on the notes, and told Rauch he would come back with a firm bid of 51 for all $ 69 million of the notes, which Rauch assured him would be acceptable. Later that day, Ambrecht came back with a bid of 50 1/2, to which Rauch responded that he would speak with the Schneiders' attorney and the Schneiders themselves, with an answer expected in the morning. (*Id.* 3.12.09.) Shortly thereafter, Rauch informed Ambrecht that nothing would happen for at least a day and a half because he needed to talk to "the girls," presumably Leslie and Susan Schneider. (*Id.* 3.12.10.) The delay was ostensibly caused by Highland's low bid of 50 1/2 when a bid of 51 or 52 was expected.

Rauch repeatedly insisted that nothing would be done on the trade that day.

By the morning of March 14, 2001, Rauch still had nothing to report from the Schneiders and stated that if he were in their position, he "would have done the trade yesterday." (*Id.* 3.14.01-02.) In a follow up call, Rauch attempted to set up a conference call between Ambrecht, Rauch, and Mr. Alterbaum, the Schneiders' attorney. (*Id.* 3.14.06.) Rauch cautiously responded to Ambrecht's impatience, stating that Mr. Alterbaum was necessary even for an "oral thing," that Rauch would not "go out on a limb" regarding whether the Schneiders had decided to trade, and reemphasized that the trade would likely be "as is" without additional guarantees or covenants. Ambrecht noted that the buyer had attorneys who would draw up documentation and that RBC planned to use the law firm Cravath, Swaine & Moore, L.L.P. Rauch and Ambrecht agreed that after the conference call, the parties would need to "write it down, write it all down," but Rauch forecasted that he would not hear back from Mr. Alterbaum until at least 5:00 p.m. that day. (*Id.* 3.14.07.) Ambrecht again expressed worry over Highland's increasing hostility.

At some point on the same day, RBC employee, identified only as Wood, spoke with a Highland employee, identified only as Ethan, prefacing the phone call by stating he did not have good news. (*Id.* 3.14.11-12.) Wood told Ethan that the trade was "subject to just about everything you can imagine," that the family was going to talk to their lawyers in order to determine

exactly what the note represents and so that everyone was clear on exactly what was being traded. (*Id.*) However, Wood assured Ethan that there should be a trade on $ 45.4 million of the notes at 52 1/2 cents on the dollar, and Fidelity (identified only as "the other buyer") would purchase Leonard Schneider's $ 23.6 million note. Consistent with Ambrect's worry, Ethan warned that if the Schneiders kept "dilly dallying, we have to go away," and that the deadline for Highland walking away from the deal was the end of the month. (*Id.*) Wood stated the parties were in agreement about the price, but the trade was subject to unidentified contingencies. Telephone calls from the next day evidence that RBC and Highland were circulating draft documentation regarding the deal. (*Id.* 3.15.02.)

Plaintiff and RBC contend that, during an unrecorded telephone conversation between Rauch and RBC on the afternoon of March 14, 2001, Rauch confirmed a sale of $ 45.4 million in notes to Highland for 51 cents on the dollar, and a sale of Leonard Schneider's $ 23.6 million note to Fidelity for 52.5 cents on the dollar. To evidence that the deal was done, Highland and RBC point to deposition testimony and affidavits of Highland and RBC employees who believed the parties had all agreed on the trade as to the price and size of the transaction. Plaintiff and RBC both claim a letter Rauch wrote to Leonard Schneider regarding compensation for Rauch's work on the deal further supports that Rauch agreed to the deal on behalf of the Schneiders. (Pl.'s Opp'n Ex. 25.) The letter is dated March 12, 2001, and sets forth possible compensations

dependent on whether all $ 69 million in notes were traded, just $ 59 million in notes, or only Leonard Schneider's $ 23.6 million note. Rauch and the Schneiders adamantly contend that they did not agree to a deal at any time, and did not agree during an unrecorded conversation on March 14, 2001.

V. The Promissory Note Deal Falls Through

On March 9, 2001, while Rauch and Ambrecht meandered through negotiations, Brad Cost, Esq., McNaughton's General Counsel, contacted the Schneiders' lawyers at JGPC, Charles Greenman, Esq., and Mr. Alterbaum. In essence, Mr. Cost informed JGPC that McNaughton had received an unsolicited inquiry from a substantial company regarding the possible purchase of McNaughton, and that the inquiry proposed an attractive price per share. The information was passed along to JGPC as a "professional courtesy" due to McNaughton's relationship with the Schneiders, and the highly confidential nature of the discussion was stressed. (Pl.'s Opp'n Ex. 71.) JGPC left the conversation feeling that the transaction was "more likely than not" to occur. (Pl.'s Opp'n Ex. 181, at 105.) Plaintiff argues that this "tip" violated McNaughton's Regulation FD (full disclosure) Policy, which stated only the CEO or CFO could disseminate material, non-public information to McNaughton securities holders,[14] and the

14. The parties dispute whether the Schneiders' notes are properly termed securities, with defendants arguing that the notes are not securities.

information could not be used "to personal advantage or to benefit others." (Pl.'s Opp'n Ex. 84; 17 C.F.R. § 243.100 (2000).)

Later on March 9, 2001, JGPC informed Leonard Schneider that "something significant" had happened with McNaughton and advised him to discontinue selling his shares of McNaughton stock. (Pl.'s Opp'n Ex. 188, at 285-86.) At a meeting with JGPC and the Schneiders on March 13, 2001, JGPC informed the Schneiders that McNaughton would likely merge or be acquired by another company. JGPC advised the Schneiders that their promissory notes would then most likely be paid in full. Mr. Alterbaum then called Rauch to stop his work on the notes, leaving him a message on March 14, 2001 at approximately 6:00 p.m.[15]

Despite that phone message, on March 15, 2001, Rauch informed Ambrecht that Rauch had not heard from the Schneiders' attorney or the Schneiders despite repeated phone calls. Rauch described their silence as "suspiciously strange," but opined that the Schneiders' attorney was reviewing the documents and that Rauch would not hear anything before Monday, March 19, 2001. (*Id.* Ex. 79, RBC 3.15.04.)

On March 14 and 15, 2001, RBC implied to Fidelity and Highland that the trade had occurred. Specifically, RBC told Highland that they were "closer, close, to

15. The message states only: "not sure Schneiders want him to proceed with phone calls." (Pl.'s Opp'n Ex. 26.)

making this . . . thing happen, subject to all kinds of documentation." (*Id.* Ex. 80C, RBC 3.15.03.) RBC told Fidelity that they had a trade on the $ 23.6 million note but that he could not confirm until the following day because the trade was contingent on documentation. (*Id.*, RBC 3.14.04.) In an internal RBC conversation, employees affirmed that the trade had occurred on all $ 69 million of the notes with the "legal stuff" of representations and warranties to be worked out on March 15, 2001. (*Id.*, RBC 3.14.05.)

On March 20, 2001, RBC was forced to return to Highland and Fidelity, informing them that the Schneiders were no longer interested in trading their notes. While there is no presented memorialization of Fidelity's reaction, Highland was upset, stating that the failure to close the deal had "implications beyond this trade." (*Id.*, RBC 3.20.03.) Highland expressed its belief that RBC had not put enough effort into closing the deal once an oral agreement on price had been reached. RBC explained that when it spoke with Highland regarding the trade, RBC qualified the trade as subject to "just about everything," including conversations between the Schneiders and their attorneys, documentation, representations, warranties, and confirmations. (*Id.*, RBC 3.20.03-04.) The parties both expressed that, though they foresaw that settling the trade would be difficult, and possibly unachievable, they thought the trade would ultimately get done. After this unsettling conversation with Highland, RBC called Rauch to ascertain the fatal blow to the deal. First, Rauch represented he was unwilling to talk with Highland

because he did not know Highland and had no obligation to speak with any of Highland's employees. (*Id.* 3.20.09.) Rauch explained the deal had fallen through because RBC failed to supply Rauch with a letter of intent on the bid of 51 cents on the dollar for the entire $ 69 million, which Rauch had repeatedly requested. RBC's Ambrecht reacted with surprise, he had thought that Rauch was only waiting for the Schneiders' attorneys to review the paperwork and get back to Rauch regarding what representations and warranties were proper. That Rauch was waiting for a letter of intent was "total news" to Ambrecht and he offered to remedy the "miscommunication" by securing a letter immediately if that would save the deal. (*Id.* RBC 725, 3.20.09-13.) Rauch reiterated that the letter of intent was necessary because RBC had adjusted its bid downward before, and that Rauch interpreted the absence of a letter of intent to mean that RBC had not secured a bid for the 51 cents on the dollar price.

Obviously, the Schneiders were not amenable to a letter of intent or firm bid at this late stage. The Schneiders retained their promissory notes and, on April 16, 2001, it was announced that Jones had agreed to purchase McNaughton. The notes were paid out in full on June 19, 2001, with the Schneiders receiving the full $ 69 million plus interest. Plaintiff instigated this litigation to recover its $ 22 million share of what it terms the Schneiders' $ 34 million windfall resulting from their refusal to consummate the trade.

Appendix D

DISCUSSION

Defendants here move for summary judgment dismissing plaintiff's and RBC's claims against defendants. RBC has cross-moved for summary judgment to dismiss the Schneider defendants third-party complaint against RBC. The Court dismisses the majority of plaintiff's claims on the merits and the remaining claims of all the parties for lack of subject matter jurisdiction.

I. Summary Judgment Standard

Movants are entitled to summary judgment if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c); *see Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23, 91 L. Ed. 2d 265, 106 S. Ct. 2548 (1986); *Holt v. KMI-Continental*, 95 F.3d 123, 128 (2d Cir.. 1996). The substantive law underlying a claim determines if a fact is material, and "only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986). It is not a court's role, in considering a motion for summary judgment, to "resolve disputed issues of fact but" rather the court should "assess whether there are any factual issues to be tried." *Knight v. U.S. Fire Ins. Co.*, 804 F.2d 9, 11 (2d Cir. 1986).

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To determine whether genuine issues of material fact exist, the Court must resolve all ambiguities and draw all justifiable inferences in favor of the nonmoving party. *See Anderson*, 477 U.S. at 255; *Holt*, 95 F.3d at 129. The moving party bears the burden of demonstrating that no genuine issue of material fact exists. *See Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157, 26 L. Ed. 2d 142, 90 S. Ct. 1598 (1970); *see Gallo v. Prudential Residential Servs., Ltd. Pshp.*, 22 F.3d 1219, 1223-24 (2d Cir. 1994). "The movant's burden will be satisfied if he can point to an absence of evidence to support an essential element of the nonmoving party's claim." *Goenaga v. March of Dimes Birth Defects Found.*, 51 F.3d 14, 18 (2d Cir. 1995). Once the moving party discharges its burden of demonstrating that no genuine issue of material fact exists, the burden shifts to the nonmoving party to offer specific evidence showing that a genuine issue of fact exists for trial. *See Celotex*, 477 U.S. at 324. The nonmoving party "must do more than simply show that there is some metaphysical doubt as to the material facts." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586, 89 L. Ed. 2d 538, 106 S. Ct. 1348 (1986). "A 'genuine' dispute over a material fact only arises if the evidence would allow a reasonable jury to return a verdict for the nonmoving party." *Dister v. Cont'l Group*, 859 F.2d 1108, 1114 (2d Cir. 1988) (citing *Anderson*, 477 U.S. at 248). The Second Circuit reviews a District Court's disposition of a summary judgment motion *de novo*. *Mario v. P & C Food Mkts.*, 313 F.3d 758, 763 (2d Cir. 2002) (quoting *Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 121 (2d Cir. 2001)).

Appendix D

II. Defendants' Motion for Summary Judgment against Highland

Plaintiff presents seven claims for relief in its complaint against defendants: (1) breach of the oral contract to sell the notes between the Schneiders and Highland; (2) alternatively, breach of the binding preliminary agreement to do the same between the Schneiders and Highland; (3) alternatively, breach of the same contract between the Schneiders and RBC, with Highland acting as a third-party beneficiary; (4) the Schneiders' tortious interference with a contract between RBC and Highland to transfer the notes; (5) the Schneiders tortious interference with the prospective business relations between RBC and Highland; (6) JGPC's tortious interference with (a) the contract between the Schneiders and Highland, (b) the binding preliminary agreement between the Schneiders and Highland, and / or (c) the contract between RBC and Highland; and, (7) JGPC's tortious interference with prospective business relations between RBC and Highland.

Defendants raise a panoply of arguments in contravention to these claims. With an eye toward judicial economy, the Court disposes of each according to subject.

A. Alleged Binding Enforceable Oral Contract to Sell the Notes

Plaintiff makes several claims which depend on the existence of a valid, enforceable oral contract that the

Schneiders' agreed to sell their notes to RBC.[16] Plaintiff and RBC aver that, on the afternoon of March 14, 2001, during an unrecorded telephone conversation, the Schneiders, via their agent Rauch, entered into a binding oral contract with RBC wherein the Schneiders agreed to trade seven of their eight McNaughton promissory notes, with a face value of $ 45.4 million, in exchange for 51 cents on the dollar or $ 23,205,000. Highland promised to pay 52.5 cents on the dollar, or $ 23,887,500, with the balance, or "spread," of $ 682,500 going to RBC. Highland claims that, because the Schneiders refused to perform their obliged trade, Highland suffered $ 22 million in damages, the principle plus interest McNaughton paid on the notes from March 14, 2001, to June 19, 2001, and is also entitled to prejudgment interest. Defendants contend that GRS was unable to bind the Schneiders to any agreement to sell their notes, and moreover, they did not intend to be bound to a contract absent a writing, as evidenced by the record and, specifically, the letter agreement with RBC. Plaintiff claims GRS was apparently authorized, that a contract existed as to all material terms and that the parties had merely to formalize their agreement in writing.

16. Plaintiff's breach of contract, breach of third party beneficiary contract, and tortious interference with contract claims all fall into this category.

Appendix D

1. GRS's Authority to Bind the Schneiders[17]

Plaintiff and RBC contend that GRS had apparent authority to bind the Schneiders to a contract to sell their notes. Apparent authority requires that: "(1) [the] principal 'was responsible for the appearance of authority in the agent to conduct the transaction in question,'" *Herbert Constr. Co. v. Cont'l Ins. Co.*, 931 F.2d 989, 993-94 (2d Cir. 1991) (quoting *Ford v. Unity Hosp.*, 299 N.E.2d 659, 664, 32 N.Y.2d 464, 473, 346 N.Y.S.2d 238 (1973)), "and (2) the third party reasonably relied on the representations of the agent." *Id.* at 994 (citing *Hallock v. State*, 474 N.E.2d 1178, 1181, 64 N.Y.2d 224, 231, 485 N.Y.S.2d 510 (1984)); *see also Doxsee Sea Clam Co. v. Brown*, 13 F.3d 550, 553-554 (2d Cir. 1994). This analysis focuses on the principal's actions, not the agent's actions. *Herbert Constr.*, 931 F.2d at 993 ("'The existence of 'apparent authority' depends upon a factual showing that the third party relied upon the misrepresentations of the agent because of some misleading conduct on the part of the principal — not the agent.'") (quoting *Ford*, 299 N.E.2d at 664, 32 N.Y.2d at 472-73)); *ITEL Containers Int'l Corp. v. Alanttrafik*

17. The parties have not raised choice of law issues, instead, the parties' briefs assumed that New York State law applies. Where the parties so assume, the Court need not address choice of law *sua sponte*. *See In re Chateaugay Corp.*, 139 B.R. 598, 602 n.3 (Bankr. S.D..N.Y. 1992) (*citing Deep South Pepsi-Cola Bottling Co. v. PepsiCo, Inc.*, No. 88 Civ. 6243, 1989 U.S. Dist. LEXIS 4639, at *24 (S.D.N.Y. May 2, 1989)). Therefore, the Court applies New York State law in accordance with the parties' briefs.

Express Servs., 909 F.2d 698, 702-03 (2d Cir. 1990) (differentiating between express and implied or apparent authority). Where the agent's actions do not involve an extraordinary transaction obviating reasonable reliance, the third party has no duty to inquire as to the scope of the agent's authority, as stated in Herbert Construction:

> Recovery based on the doctrine of apparent authority does not require that the third party have inquired into the scope of the agent's authority . . . the duty to inquire only arises when "the facts and circumstances are such as to put him on inquiry," the transaction is "extraordinary," or the "novelty" of the transaction alerts the third party to the danger of fraud.

931 F.2d at 995-96 (citations omitted).

Here, a genuine material issue of fact exists as to whether the Schneiders' actions compelled RBC and Highland's belief that GRS had the authority to bind the Schneiders. Relevantly, the Schneiders conducted all communications with RBC via GRS, the letter agreement states that GRS represents the Schneiders, and throughout negotiations with RBC, GRS entertained and offered bids on behalf of the Schneiders. Further, securities brokers are generally able to engage in highly lucrative transactions on behalf of the underlying holders of notes, bonds, and securities. Thus, the instant transaction would not be so extraordinarily

out of the parameters of a broker's duties as to bar reasonable reliance on GRS's authority. That GRS repeated it could not act without the Schneiders' approval does not require summary judgment as, if GRS falsely represented the Schneiders had approved of the bid on March 14, 2001, RBC may have reasonably relied on that statement based on the Schneiders' previous actions. This, therefore, does not render moot the Schneiders' and GRS's adamant contention that they did not agree to a sale of the notes. However, should the jury find that GRS did so agree on March 14, 2001, the jury can also properly consider whether Highland, via RBC, reasonably relied on the Schneiders' actions indicating that GRS had the authority to bind the Schneiders for purposes of this transaction.

2. Existence of a Contract

In order to claim existence of a contract, there must be evidence of "a meeting of the minds, demonstrating the parties' mutual assent and mutual intent to be bound." *Oscar Producs., Inc. v. Zacharius*, 893 F. Supp. 250, 255 (S.D.N.Y. 1995). "Where the alleged contract is oral, plaintiff has a particularly heavy burden to establish objective signs of the parties' intent to be bound . . . because a primary concern for courts in such disputes is to avoid trapping parties in surprise contractual obligations that they never intended." *Id.* (citing *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69, 72 (2d Cir. 1989); *Winston v. Mediafare Entm't Corp.*, 777 F.2d 78, 80 (2d Cir. 1985)). However, at the summary judgment stage, whether the parties

to an oral agreement intended to be bound is commonly a question of fact for the jury unless the jury could not "rationally agree" with plaintiff's characterization. *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1537 (2d Cir. 1997) (collecting cases) (reversing grant of summary judgment where defendant had not obviated material facts as to whether the common custom in the banking industry was to be bound by an oral commitment prior to due diligence). Further, under New York law, "a contract need not be reduced to writing to be effective 'where all the substantial terms of a contract have been agreed on, and there is nothing left for future settlement.'" *Totalplan Corp. of Am. v. Colborne*, 14 F.3d 824, 832 (2d Cir. 1994). In determining whether a binding oral contract exists absent a writing, the court must determine if a genuine issue of material fact exists as to whether the parties reached an agreement on material terms, and the parties intended to be bound to that agreement absent a writing. *Evolution Online Sys., Inc. v. Koninklijke PTT Nederland N.V.*, 145 F.3d 505, 508-509 (2d Cir. 1998).

Based on the present record, a rational juror could find that the purported oral agreement encompassed all material terms between the Schneiders / GRS and RBC. Plaintiff and RBC both contend that an agreement had been reached as to the price (51% of value) and size ($ 69 million value) for sale of the notes. These numbers are certainly where the parties left their negotiations on the last recorded conversation. Thus, if a jury finds Highland and RBC's witnesses more credible than defendants, a jury could also find that these were the

terms of the agreement. Defendants counter that this agreement did not contain the required representations and warranties regarding the notes. However, these representations and warranties may simply be standard, boiler-plate legalese tacked on to any agreement to sell individual notes. *See Cinema N. Corp. v. Plaza at Latham Assoc. & Hoyt's Cinema*, 867 F.2d 135, 140 (2d Cir. 1989) (holding that, where not apparent that missing terms were deemed material by the parties, whether those terms were material is a question of fact for the jury). If so, then all substantive terms were agreed upon and the representations and warranties did not necessarily require further negotiations. It is equally plain to the Court that defendants have demonstrated there is insufficient support for Highland's contention that the Schneiders had knowledge, and thereby agreed, to the portion of the purported contract wherein Highland promised to pay 52.5 cents on the dollar. RBC is explicit in recorded telephone conversations that the details of the Highland side of the deal were to be kept secret from the Schneiders and GRS. Neither plaintiff nor RBC have raised a material issue of fact as to this obfuscation.

In determining whether the parties intended to be bound absent a written agreement, the Court must analyze the record in light of four factors: "(1) whether the parties have expressly reserved the right not to be bound without a written contract; (2) whether there has been partial performance of the contract; (3) whether the parties have agreed to all of the terms of the alleged contract; (4) whether the alleged agreement is the type

that is usually committed to writing." *Evolution Online*, 145 F.3d at 509 (citing *Winston v. Mediafare Enter. Corp.*, 777 F.2d 78 (2d Cir. 1986)).

Defendants argue that they expressly reserved the right not to be bound absent a writing in their letter agreement with RBC. It is unclear that the letter agreement is an express reservation of this right. The applicable paragraph of the letter agreement states: "Any possible resale of some or all of the Notes would be through an exemption from registration under the securities laws of the United States and other applicable jurisdictions. You [*GRS] understand that any such transaction is subject to definitive documentation in compliance with applicable law." It is not sufficiently obvious for purposes of a motion for summary judgment that the "definitive documentation" language is applicable to defendants' intention to be bound to an oral agreement.. The language does not speak to the point at which the parties would be bound but rather only requires that their agreement be memorialized in writing before the transfer would be complete. Just as in *Lazard Freres*, 108 F.3d at 1537, the parties can be held to their bargain even if that bargain was subject to future written memorialization or due diligence. The other factors also do not sway the determination decidedly to defendants' camp. Though there was no performance on the contract, in plaintiff's rendition of the facts, the parties had agreed to all material terms. In defendants' favor, this contract does seem the type that would be reduced to writing prior to binding the parties. *See infra* Discussion Part II.A. (finding the

purported oral agreement falls within New York's statute of frauds); *Lazard Freres*, 108 F.3d at 1538 n.4 (Defendant "may be able to use the statute of frauds as an indication of the parties' intent not to be bound by the oral agreement."). However, as no *Winston* factor is dispositive, *Evolution Online*, 145 F.3d at 509, and as plaintiff and RBC have proffered evidence that brokers are routinely bound by oral representations, this factor alone would not necessarily preclude a rational juror from finding that the parties intended to be bound absent a writing.

3. Whether the Purported Oral Agreement to Sell the Notes Falls Within the Statute of Frauds

The New York Uniform Commercial Code bars enforcement of purported oral agreements to sell personal property in excess of $ 5000, unless the agreement is memorialized by a writing (1) evidencing that a contract for sale has been entered into by the parties, (2) identifying the property sold and the price, and (3) signed by the party against whom enforcement is sought. N.Y. U.C.C. § 1-206(1). This statutory bar does not apply to the sale of, *inter alia*, securities. N.Y. U.C.C. § 8-113 ("[A] contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making."); *see also The Wharf (Holdings) Ltd. v. United Int'l Holdings,*

Inc., 532 U.S. 588, 595, 149 L. Ed. 2d 845, 121 S. Ct. 1776 (2001) ("Oral contracts for the sale of securities are sufficiently common that the Uniform Commercial Code and statutes of frauds in every State now consider them enforceable."). Highland alleges that the notes are securities, or alternatively, that defendants are promissorily estopped from asserting the statute of frauds as a defense. A security is defined as:

> an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:
>
> (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
>
> (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations; and
>
> (iii) which (a) is, or is of a type, dealt in or traded in securities exchanges or securities markets; or (b) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

N.Y. U.C.C. § 8-102(a)(15). A purported security must meet all three of these criteria in order to be considered a security for statute of frauds purposes. *Id.* official cmt. 15.

The Court finds that promissory notes are not securities under this definition as a matter of law because there is no genuine issue of material fact that the promissory notes meet the first prong of the above tripartite test. The promissory notes are not represented by a certificate, but rather are signed by the maker, McNaughton, and represented as a note of payment due. They are clearly not bearer notes as each note is payable only to the individual Schneider named as payee. N.Y. U.C.C. § 8-102(2), official cmt. 2. Nor are they registered notes as the notes specifically state that "this note has not been registered." (Defs.' Mem. Exs. 290-97.)

Further, though transfer of the note requires registration under the securities laws absent counsel's advice to the contrary, there is no evidence that the transfer is registered on "books maintained for that purpose by or on behalf of the issuer." First, the notes themselves do not reference the procedure for transfer, only stating that the notes must be registered under the federal securities laws absent "an opinion of counsel to the maker that such registration is not required." (*Id.*, heading of each.) Plaintiff claims that the notes were recorded on McNaughton's books, however, those books were not of the kind maintained for the purpose of recording transfers of this so-called "series" of purported securities, but rather were McNaughton's general books, as evidenced on the face of the notes in Section 8(c). That Section outlines general affirmative covenants wherein McNaughton promises to comply with tax laws (*id.* § 8(a)), preserve its existence (*id.* §

8(b)), keep records and books of account in accordance with generally accepted accounting principles ("GAAP") (*id.* § 8(c)), and properly insure the company (*id.* § 8(d)). As a whole, this section merely requires McNaughton to operate as a proper company in accordance with the laws of the United States in order to maintain its good standing while the promissory notes are viable. *Cf. Sure-Trip, Inc. v. Westinghouse Eng'g & Instrumentation Servs. Div.*, 47 F.3d 526, 533 (2d Cir. 1995) (When interpreting a contract, "not only should the entire contract be considered, but its parts must be reconciled . . . ."). The GAAP requirement does not impose on McNaughton a duty to maintain records of any transfer of the promissory notes and cannot conceivably be construed as such. Thus, defendants have demonstrated that there is no material fact in question on this point and plaintiff has failed to illuminate a genuine issue for the Court.[18]

The Court's determination that the promissory notes are not securities is in line with the scant caselaw on the subject. Plaintiff and RBC point to federal definitions of securities under the federal securities laws,

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18. Plaintiff touts the testimony of McNaughton's CFO Amanda Bokman as supporting plaintiff's position, however, that testimony is irrelevant to this point as it solely affirmed that McNaughton kept records in accordance with GAAP on which promissory notes were included as a company liability, and does not reference whether ownership or transfer of ownership was recorded. Further, plaintiff conclusively states that transfer of the notes would necessarily be registered on McNaughton's books and records but points to no facts or law supporting its conclusion.

however those definitions do not control whether a note is a security for statute of frauds purposes under the N.Y. U.C.C. The federal statutes and the statute of frauds are differently purposed. The former defines securities in an effort to regulate the markets and exchanges. The latter is meant to "guard against the peril of perjury; to prevent the enforcement of unfounded fraudulent claims." *Morris Cohon & Co. v. Russell*, 245 N.E.2d 712, 715, 23 N.Y.2d 569, 574, 297 N.Y.S.2d 947 (1969). Moreover, New York law is not consistent with itself, as different statutes define securities more narrowly or more broadly, presumably because the definitions support different legislative intents. *See 306-100th ALH Props. Ten v. St. Owners Corp.*, 191 A.D.2d 1, 8-9, 600 N.Y.S.2d 443 (App. Div. 1993) (discussing the alternate definitions of securities in the N.Y. U.C.C. and the N.Y. General Obligations Law ("N.Y. G.O.L.")).

New York courts have generally expanded the definition of securities under the statute of frauds where the instruments alleged to be securities represent an investment in the issuing company. *See id.* at 10 (including shares of stock in cooperative corporations in the definition of securities where "it is clear that the subject shares were purchased and used for no other purpose than investment"); *Cohn, Ivers & Co. v. Gross*, 56 Misc. 2d 491, 493-94, 289 N.Y.S.2d 301, 304 (App. Div. 1968) (defining securities as, alternatively (1) an instrument for the payment of money "for the purpose of financing and investment," (2) representing "title or equity," (3) financing an enterprise, or (4) designed for

investment, and finding that a "call" stock agreement did not meet the criteria). The promissory notes here do not fit any of these categories. Rather, the notes purely evidence a debt resulting from McNaughton's purchase of the Schneiders' family business, a debt which did not finance McNaughton's company analogous to a stock share, the quintessential security under the N.Y. U.C.C. § 8-103(a), entitled "Rules for Determining Whether Certain Obligations and Interests are Securities or Financial Assets." That the debt is payable primarily in cash, or if McNaughton is unable to pay in cash, in stock, does not remove the purported oral agreement to transfer $ 69 million in promissory notes from the statute of frauds. *See, e.g., Cohn, Ivers & Co.*, 56 Misc. 2d at 495, 289 N.Y.S.2d at 305 ("While it is a contract or chose in action concerning a security, it is not the security itself" and thus the purported contract is not excepted from the statute of frauds as a security).[19] High yield debt instruments made payable to individuals for the sole purpose of purchasing an asset rather than financing a company have not been deemed securities under New York law and this Court is not inclined to so expand the definition regardless of the subjective understanding of securities brokers. (*See* Pl.'s Opp'n at 54 (arguing the Court's decision "would

19. Indeed, plaintiff's own case citation supports the Court's finding that these promissory notes are not analogous to subordinated debenture securities for they were not made for the purpose of financing and investment. (*See* Pl.'s Opp'n at 55 (quoting *Allegaert v. Chemical Bank*, 657 F.2d 495, 507 (2d Cir. 1980) ("Subordinated debentures are 'commonly dealt in for the purpose of financing and investment.").

derail the customary practice in the bank and bond debt trading industry).)[20]

RBC argues that the oral agreement is a qualified financial contract under New York General Obligation Law § 5-701(b), and thus exempted from the statute of frauds. *See* N.Y. U.C.C. § 1-206(3) (exempting qualified financial contracts from the statute of frauds). A "qualified financial contract" is an agreement between parties who are not natural persons and the agreement is, relevantly: "for the assignment, sale, trade, participation or exchange of indebtedness or claims relating thereto arising in the course of the claimant's business or profession (including but not limited to commercial and/or bank loans, choses in action arising under or in connection with loan agreements and private notes, and including forward sales)." *Id.* (b)(2)(i). RBC concedes that this exception did not come into effect until October 5, 2002, well after the alleged oral contract was entered into, on or about March 14, 2001. In support of its plea for retroactive application of the statute, RBC cites one case finding that a "repo" agreement, one where a seller agrees to transfer specified securities to a buyer for payment and simultaneously agrees "to repurchase the securities at the original price" plus

20. Notably, the recorded conversations indicate that GRS, RBC and Highland understood that they were in a rare situation because the transaction was between the Schneiders, as individuals, and commercial entities. There are several statements to the effect that trade negotiations with individuals are more tenuous, riskier, and that individuals' decisions are not governed by brokers' mores.

interest on a future date, for the transfer of United States Treasury Notes, was a qualified financial contract. *See Lehman Bros. Inc. v. Canadian Imperial Bank of Commerce*, 97 Civ. 8226, 2000 U.S. Dist. LEXIS 13979, at *3-4 (S.D.N.Y. Sept. 27, 2000). The Court is at a loss as to how Lehman is applicable to the case at hand where there was no simultaneous repurchase agreement between the Schneiders or GRS and RBC, Lehman did not involve the sale of promissory notes payable to individuals which require representations and warranties of the legitimacy of the transfer, and the parties in Lehman disputed the terms of their agreement, not whether one existed. *See* generally *id.* Notably, the statutes' case notes indicate no incident of retroactive application of amendments. N.Y. G.O.L. § 5-701(b), case note 2. Nor does RBC's contention that "although the amendment [including trades on commercial promissory notes as qualified financial contracts] came after the trade in question, it simply codified the prior understanding in the marketplace and should be applied here," support retroactive application. (RBC's Mem. at 33.) The statute in effect at the time of the transaction is the one that guided the parties' understanding of their obligations during the negotiations. However, the Court need not reach a definitive decision on the retroactive application argument because the record does not sufficiently evidence the oral contract as required by the statute.

In order to be exempt from the statute of frauds, a qualified financial contract must be sufficiently evidenced by, applicably, either "electronic communication (including, without limitation, the

recording of a telephone call or the tangible written text produced by computer retrieval), admissible in evidence under the laws of this state, sufficient to indicate that in such communication a contract was made between the parties," or an admission by the party against whom enforcement is sought in a "pleading, testimony or otherwise in court that a contract was made." *Id.* (b)(3)(a), (c). RBC points to no recorded telephone conversation between GRS and RBC "to indicate that in such communication a contract was made between the parties," as required by Section 5-701 (b)(3)(a), nor any admission by the Schneiders, their purported agent GRS, or their attorneys JGPC, on the fully developed record at the close of discovery, that a contract was made. All recorded communications between GRS and RBC prior to the alleged agreement demonstrate only that the parties were negotiating a price, while the conversations afterwards demonstrate that GRS did not enter into an agreement because it never received a letter of intent. *Cf. Lehman*, 2000 U.S. Dist. LEXIS 13979, at *39 (finding for plaintiff where defendants' employee's telephonic admission of his understanding of the purported agreement aligned with plaintiff's understanding); *Ferrer v. Samuel*, 192 Misc. 2d 533, 535, 746 N.Y.S.2d 242, 244 (1st Dist. 2002) (finding sufficient evidence of a loan agreement where defendant admitted he owed money to plaintiff). Moreover, defendants and their supposed agent have remained steadfast in their denial that any contract was made, thus, there is no genuine issue of material fact that the defendants or their alleged agent made or would make an admission as to the purported contract's existence. *See, e.g., Khreativity Unlimited v. Mattel, Inc.*, 101 F. Supp. 2d

177, 182 (S.D.N.Y. 2000) (granting summary judgment because the affidavits and stipulations on the record did not qualify as judicial admissions) (citing *Am. Steel Erectors, Inc. v. Lehrer McGovern Bovis, Inc.*, No. 94 Civ. 6253, 1997 U.S. Dist. LEXIS 2990, at *14 n.7 (S.D.N.Y. Mar. 18, 1997) ("A judicial admission of the existence of a contract must be clear and unequivocal to take the contract out of the statute of frauds.")).[21]

Accordingly, unless plaintiff and RBC's claim that defendants are promissorily estopped from asserting a statute of frauds defense, enforcement of the purported oral contract beyond $ 5000 is barred by N.Y. U.C.C. § 1-206. *See Lazard Freres*, 108 F.3d at 1538 (unwilling to entertain a statute of frauds defense raised for the first time at oral argument on appeal, because plaintiff had no opportunity to rebut, present a promissory estoppel argument, and, "the contract would have been enforceable up to $ 5,000") (citing *Grappo v. Alitalia Linee Aeree Italiane, S.p.A.*, 56 F.3d 427, 431 (2d Cir. 1995)).

4. Promissory Estoppel and the Statute of Frauds

New York recognizes an exception to the statute of frauds defense where imposition of the statute will contravene its own purpose by effecting a fraud. "It

21. The Court notes also that RBC's argument appears to defy the spirit of the law, for, although the purported agreement was between two non-natural persons, namely GRS and RBC, the underlying indebtedness to be transferred was owed to four private citizens and plaintiff and RBC argue GRS was acting on the Schneiders' behalf.

would be quite antagonistic to the spirit of a statute designed to prevent fraud, if it might be availed of to cover fraud." *Messner Vetere Berger McNamee Schmetterer Euro RSCG v. Aegis Group PLC*, 150 F.3d 194, 196 (2d Cir. 1998) (quoting *McKinley v. Hessen*, 202 N.Y. 24, 30, 95 N.E. 32, 34 (1911)).. In this respect, plaintiff and RBC argue that defendants are promissorily estopped from shielding themselves with the statute because JGPC referred to the notes as securities, and the Schneiders hired securities brokers GRS and RBC to sell the notes expecting that RBC would act toward that end. Highland claims it suffered the detriment of losing a lucrative high-yield investment, while RBC claims that it suffered the detriment of lost customer relationships with Highland and Fidelity.

In order to estop defendants from asserting a statute of frauds defense, there must be an "indication that [defendants] caused [plaintiff and RBC] 'to irremediably alter [their] situation' such that 'the interposition of the statute against performance [would constitute] a fraud.'" *Grappo*, 56 F.3d at 433 (quoting *Woolley v. Stewart*, 118 N.E. 847, 848, 222 N.Y. 347, 350-51 (1918)). "'The strongly held public policy reflected in New York's Statute of Frauds would be severely undermined,' however, 'if a party could be estopped from asserting it every time a court found that some unfairness would otherwise result.'" *Id.* This is plainly not a case where application of the statute of frauds would be unconscionable, as the detriment cited does not rise to the level of irremediable harm. *See id.; Philo Smith & Co. v. USLIFE Corp.*, 554 F.2d 34, 36 (2d Cir.

1977) (requiring that the claimed detriment be irreversible and that use of the statute of frauds defense would itself constitute a fraud) (quoting *Woolley*, 118 N.E. at 848, 222 N.Y. at 350-51)); *Four Star Capital Corp. v. Nynex Corp.*, 183 F.R.D. 91, 103 (S.D.N.Y. 1997). Like in *Philo Smith*, the detriment here claimed is that which logically followed defendants' justified refusal to honor a void purported oral contract, as is their right under the statute of frauds. It cannot be defendants' undoing that RBC misrepresented the validity of the oral agreement to Highland, nor does defendants' vague knowledge of the McNaughton-Jones merger affect either the validity of this contract under the statute or the relatively benign nature of Highland and RBC's claimed detriment. *See id.*

5. Conclusion

According to the above reasoning, the purported oral contract falls within New York's statute of frauds, N.Y. U.C.C. § 1-206, and is therefore only enforceable up to $ 5000. Plaintiff and RBC are thus limited to recovery up to that amount on all claims relying on the validity of the oral contract.

B. Plaintiff's Claim the Schneiders Breached a Contract with Highland

In this permutation of plaintiff's claim, Highland argues that both GRS and RBC acted as the Schneiders agents in binding the Schneiders to a contract with Highland to sell the notes. First, the Court notes that

because the underlying contract falls within N.Y. U.C.C. § 1-206, as stated *supra* Discussion Part II.A., Highland's recovery is limited to $ 5000 under this claim.

Defendants aver that this Court should not recognize plaintiff's claim because (1) the letter agreement evidences that the parties did not intend to be bound absent a writing; (2) there is no privity of contract between the Schneiders and Highland; and (3) the trade did not occur as neither the Schneiders nor GRS agreed to the 51 cent bid. Because the Court finds that there is no evidence supporting plaintiff's theory that RBC acted as an agent with the authority to bind the Schneiders to a contract with Highland, and therefore privity between plaintiff and defendants is lacking, the Court limits its discussion to that aspect of defendants' argument.

Non-performance of a contractual duty constitutes a breach of contract. Restatement (Second) of Contracts § 235 (1981). To maintain a breach of contract claim in New York, complainant must show by a preponderance of the evidence: (1) the existence of a contract; (2) the complainant's performance; (3) breach by defendants; and, (4) damages. *First Investors Corp. v. Liberty Mut. Ins. Co.*, 152 F.3d 162, 168 (2d Cir. 1998); *Harsco Corp. v. Segui*, 91 F.3d 337, 348 (2d Cir. 1996). The issue here is the existence of a valid contract. In order to state a claim for the existence of a valid contract, plaintiff must plead facts supporting the finding of an offer, acceptance, and "a meeting of the minds demonstrating the parties' mutual assent and intent to be bound." *Oscar Prods.*, 893 F. Supp. at 255. Further, plaintiff can

only assert a breach of contract claim against defendants if the parties were in privity of contract.[22] *See Morse/Diesel, Inc. v. Trinity Industries, Inc.*, 859 F.2d 242, 247 (2d Cir. 1988) (quoting *Widett v. U.S. Fid. & Guar. Co.*, 815 F.2d 885, 886 (1987)) ("In New York, . . . professionals are not liable either in tort or contract absent privity.").

Plaintiff attempts to overcome the glaring problem that neither Highland nor the Schneiders were a direct party to the note negotiations by stating that Rauch was authorized to bind the Schneiders as their agent to a sale of the notes to RBC, and that RBC, in turn, was authorized by Rauch to act as the Schneiders' agent to bind them to a sale of their notes to Highland. Plaintiff boldly claims that RBC's role as a riskless principal, buying the notes from the Schneiders and immediately selling them to Highland at a profit or 1 1/2 cents on the dollar, is akin to acting as the Schneiders' agent during this transaction. Notably, defendants and RBC vehemently deny that RBC acted as the Schneiders' agent during this transaction.

"Agency is a legal concept which depends upon the existence of required factual elements: the manifestation by the principal that the agent shall act for him, the agent's acceptance of the undertaking and the understanding of the parties that the principal is to be

22. The exception to this rule is if plaintiff is an intended third party beneficiary to the contract. *See infra* Discussion Part II.D; *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595, 600 (2d Cir. 1991).

in control of the undertaking." Restatement (Second) of Agency § 1 cmt. b (1958). An express agency relationship is created "by written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account." *Itel Containers Int'l Corp v. Atlanttrafik Express Serv. Ltd.*, 909 F.2d 698, 703 (2d Cir. 1990) (quoting Restatement (Second) of Agency § 26 (1958)). That defendants and RBC both deny any agency relationship evidences that this standard is not met. Plaintiff claims that RBC's denial is specious based on its internal conversations defining itself as a representative of the Schneiders. (*See* Pl.'s Opp'n Ex. 78, RBC 896, 1.25.26.) However, during this twelve minute conversation between Wood and Ambrecht of RBC, the men emphasize that RBC is a principal buying the bonds from the Schneiders and selling them to Highland. Further, the men strategize as to how best disguise from the Schneiders that RBC is receiving a 1 1/2 cent on the dollar profit from this transaction. This conversation belies plaintiff's conclusion that an agency relationship existed as RBC was not acting "on behalf, at the behest, or for the benefit" of the Schneiders but rather was acting for its own benefit. *See Cabrera v. Jakabovitz*, 24 F.3d 372 (2d Cir. 1994).

Plaintiff also points to the letter agreement, supra Background Part IV, as establishing that RBC was authorized to bind the Schneiders to a sale of their notes. The letter agreement does not support Highland's contention as it merely states that Rauch represents the Schneiders as to the possible resale of their notes;

nowhere is RBC authorized to sell the notes. Nor is plaintiff's argument that a "riskless principal" is equal to an agent tenable. In support of this argument, plaintiff cites law review and other trade journal articles which analogize the riskless principal relationship to that of an agent as the riskless principal also "assumes no market risk" in the transaction between the seller, here the Schneiders, and the secondary buyer, here Highland. An analogy is not a legal equivalent, however, and RBC's ability to hold Highland to an assumed firm bid to buy had Highland reneged does not create a contract between Highland and the Schneiders.

A theory, though not pled in so many words, of apparent authority, also fails because there is no evidence that the Schneiders or Rauch conducted themselves in a way that misrepresented RBC's role in this arrangement. *See Ford v. Unity Hosp.* 32 N.Y.2d 464, 472-73, 299 N.E.2d 659, 664, 346 N.Y.S.2d 238 (1973); *see also ITEL Containers*, 909 F.2d at 703 ("[i]n order to determine whether there was implied authority, the court must focus on the acts of the principal in relation to the third party."). Plaintiff artfully crafts a legal theory wherein Rauch assumes the role of the principal conducting himself in a way that would mislead Highland with respect to RBC's role. However, this theory is to no avail when imposed on the facts of this case for, even if the Court assumes that Rauch knew of Highland's presence in this transaction, Rauch did not conduct himself in a way that would show RBC to be the Schneiders' agent. On the contrary, Rauch at all times acted as RBC's adversary engaged in negotiations regarding the price of the notes and constantly

reiterated his need to return to the Schneiders for approval of any bids. Also, RBC's conversations with Highland necessarily put Highland on notice that RBC did not have the authority to bind the Schneiders. Thus, if Highland did rely on RBC's alleged role as the Schneiders' agent as deputized by Rauch, such reliance was manifestly unreasonable. *See Herbert Constr.*, 931 F.2d at 995-96.

As the above are the only links plaintiff points to between the Schneiders and Highland, a claim for breach of contract cannot lie as a matter of law. Therefore, the Court grants defendants' motion for summary judgment dismissing plaintiff's claim for breach of contract between the Schneiders and Highland on the merits.

C. Plaintiff's Claim the Schneiders Breached a Binding Preliminary Agreement with Highland

Alternatively, plaintiff asserts upon the same theory as its breach of contract claim, that the Schneiders' refusal to consummate the trade of their notes with Highland breached a binding preliminary agreement. "Ordinarily, where the parties contemplate further negotiations and the execution of a formal instrument, a preliminary agreement does not create a binding contract." *Adjustrite Sys., Inc. v. GAB Bus. Servs., Inc.*, 145 F.3d 543, 548 (2d Cir. 1998). New York state law does provide for two exceptions to this general rule, a binding preliminary agreement and a binding preliminary commitment. A binding preliminary agreement exists

where the parties agreed on "all the points that require negotiation but agree to memorialize their agreement in a more formal document." *Id.* A binding preliminary commitment exists where the parties "agree on certain major terms but leave other terms open for further negotiation" and manifest an intent to be bound to the preliminary commitment to negotiate in good faith. *Id.* However, the Schneiders cannot be held liable to Highland under either theory because, as demonstrated above, *supra* Discussion Part II.B.., the Schneiders were not parties to any alleged agreement with Highland. Therefore, plaintiff's claim for breach of preliminary agreement as to the Schneiders and Highland cannot stand as a matter of law and is dismissed on the merits.

D. Plaintiff's Claim as Third Party Beneficiary to a Schneider / RBC Contract

Alternatively, plaintiff claims that it was an intended third party beneficiary to the purported oral agreement between the Schneiders and RBC. Like the underlying contract, plaintiff's ability to recover under this theory is limited to $ 5000 pursuant to N.Y. U.C.C. § 1-206. *BAII Banking Corp v. UPG, Inc.*, 985 F.2d 685, 697 (2d Cir. 1993) (finding that a third party beneficiary has "no greater right to enforce a contract than the actual parties to the contract"). In order to claim third party beneficiary status, plaintiff must allege: "'(1) the existence of a valid and binding contract between other parties, (2) that the contract was intended for his benefit and (3) that the benefit to him is sufficiently immediate, rather than incidental, to indicate the assumption by the contracting parties of a duty to compensate him if

the benefit is lost.'" *State of Cal. Publ. Employees' Ret. Sys. v. Sherman & Sterling*, 95 N.Y.2d 427, 434-35, 741 N.E.2d 101, 104, 718 N.Y.S.2d 256 (2000) (quoting *Burns Jackson Miller Summit & Spitzer v. Lindner*, 59 N.Y.2d 314, 451 N.E.2d 459, 464 N.Y.S.2d 712 (1983)); *Mortise v. United States*, 102 F.3d 693, 697 (2d Cir. 1996). The Restatement (Second) of Contracts further guides New York courts, stating that a third party is an intended beneficiary if: "recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and . . . the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance." Restatement (Second) of Contracts § 302(b) (1981) (adopted in *Fourth Ocean Putnam Corp. v. Interstate Wrecking Co.*, 66 N.Y.2d 38, 45, 485 N.E.2d 208, 495 N.Y.S.2d 1 (1985)). Finally, the identity of an intended third party beneficiary need not be expressed in the contract, *Trans-Orient Marine Corp. v. Star Trading & Marine, Inc.*, 925 F.2d 566, 573 (2d Cir. 1991); however, "the parties' intent to benefit a third party must be shown on the face of the agreement," *In re Gulf Oil / Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712, 733 (S.D.N.Y. 1989). Absent any facts to this effect, plaintiff may, at best, be deemed an incidental beneficiary with no enforceable rights under the alleged contract. *See McPheeters v. McGinn, Smith & Co.*, Inc., 953 F.2d 771, 773 (2d Cir. 1992) ("A third-party beneficiary exists, however, 'only if the parties to that contract intended to confer a benefit on him when contracting; it is not enough that some benefit incidental to the performance of the contract may accrue to him.") (quoting *Kyung Sup Ahn v. Rooney Pace, Inc.*, 624 F. Supp. 368, 371 (S.D.N.Y. 1985)).

Appendix D

Defendants argue that Highland could not have been an intended third party beneficiary because neither the Schneiders nor GRS knew of Highland's existence prior to the time the purported contract was effective. Further, defendants contend that RBC was acting for its own benefit and therefore Highland is not the only party with recovery rights under the contract. Plaintiff counters that a material issue of fact exists as to whether Highland's existence was known and that GRS and RBC intended that the contract benefit Highland.

The Court finds that a material issue of fact exists as to whether Highland was an intended third party beneficiary if the contract is found to exist. New York has "emphasized when upholding the third party's right to enforce the contract that no one other than the third party can recover if the promisor breaches the contract," "or that the language of the contract otherwise clearly evidences an intent to permit enforcement by the third party as by fixing the rate or price at which the third party can obtain services or goods," *Fourth Ocean Putnam*, 66 N.Y.2d at 45 (citations omitted). Here, both RBC and Highland can potentially recover under the contract. Further, the language of the purported contract specifically obscures the details of Highland's enforcement right as the telephone calls make clear that RBC sought to veil its price agreement with Highland from GRS and the Schneiders.

However, the oral agreement was prefaced on RBC's status as a "riskless principal," purchasing the notes in order to immediately sell them to an unidentified third

party. That either GRS or the Schneiders directly were aware of RBC's status is evidenced by the many recorded conversations between GRS and RBC wherein the parties reference RBC's "guy," indicating that there was a second purchaser RBC was negotiating with in order to off-load the notes as soon as RBC consummated the deal. Though GRS and the Schneiders may not have known Highland by name nor the terms of the benefit to Highland, the telephone conversations raise a factual issue as to whether defendants or their agent were aware and intended that the transaction would ultimately confer the benefit of ownership of the notes to a third party. The immediacy of the anticipated transfer of ownership from RBC to Highland satisfies the third prong of the above test for intended third party beneficiary status.

Accordingly, plaintiff's claim for breach of contract as a third party beneficiary to the alleged contract between the Schneiders and RBC survives because a genuine issue of material fact exists as to whether the parties intended to benefit Highland when entering into the contract.

E. Schneiders and JGPC Alleged Tortious Interference with Contract Between RBC and Highland

In New York State, in order to recover for tortious interference with a contract, "a complainant must prove the existence of a valid and enforceable contract between plaintiff and a third party, the defendants' knowledge of that contract, and defendants' improper intentional interference with its performance," *Enercomp, Inc. v.*

McCorhill Publ'g, Inc., 873 F.2d 536, 541 (2d Cir. 1989), "without reasonable justification." *Jews for Jesus, Inc. v. Jewish Cmty. Relations Council of N.Y.*, 968 F.2d 286, 292 (2d Cir. 1992); *see Int'l Minerals & Res., S.A. v. Pappas*, 96 F.3d 586, 595 (2d Cir. 1996) (citing, *inter alia*, *Kronos, Inc. v. AVX Corp.*, 612 N.E.2d 289, 292, 81 N.Y.2d 90, 94, 595 N.Y.S.2d 931 (1993), as stating New York State law's four elements for tortious interference with contract).

Plaintiff's claim here fails because there is no issue as to defendants' knowledge of a valid and enforceable Highland / RBC contract. First, the Court notes that any contract for the sale of the notes is limited by the statute of frauds, N.Y. U.C.C. § 1-206, and thus, any recovery for tortious interference with that contract is similarly limited. *See Nifty Foods Corp. v. The Great Atl. & Pac. Tea Co.*, 614 F.2d 832, 837-838 (2d Cir. 1980). Second, Highland points to no contract between itself and RBC of which the Schneiders, GRS, or JGPC had knowledge. As stated supra, Discussion Parts II.A.2., II.B., RBC was decidedly coy regarding the details of its relationship with the buyer on whose behalf RBC acted as a riskless principal. Though the Court finds above that a material issue exists concerning whether the Schneiders and RBC intended their own alleged contract ultimately to benefit Highland, the Court finds there is no evidence that either the Schneiders, GRS, or JGPC knew RBC and Highland had entered into a separate binding contract. Highland attempts to leap this hurdle by pointing to the testimony of RBC and Highland employees regarding their belief that a contract existed, however, those employees' subjective understanding does not impute knowledge of a contract

to the Schneiders, GRS, or JGPC.

Therefore, the Court dismisses plaintiff's claim for tortious interference with a purported contract between Highland and RBC as to all defendants on the merits.

F. Schneiders and JGPC Alleged Tortious Interference with Prospective Business Relationship Between RBC and Highland

To establish a claim for tortious interference with prospective business advantage, plaintiff must prove that: (1) there was a business relationship with a third party; (2) defendants "knew of that relationship and intentionally interfered with it"; (3) defendants either acted "solely out of malice" or used wrongful means; and, (4) defendants' "interference caused injury to the relationship" with the third-party. *See Carvel Corp. v. Noonan*, 350 F.3d 6, 17 (2d Cir. 2003); *see also Lombard v. Booz-Allen & Hamilton, Inc.*, 280 F.3d 209, 214 (2d Cir. 2002); *Purgess v. Sharrock*, 33 F.3d 134, 141 (2d Cir. 1994). This cause of action has a "limited scope." *Piccoli A/S v. Calvin Klein Jeanswear Co.*, 19 F. Supp. 2d 157, 168 (S.D.N.Y. 1998).

This tort must be supported by evidence of plaintiff's relationships with specific third parties with which defendants interfered. *See Four Finger Art Factory, Inc. v. DiNicola*, No. 99 Civ. 1259, 2000 U.S. Dist. LEXIS 1221, at *23-24 (S.D.N.Y. Feb. 9, 2000); *Minnesota Mining & Mfg. Co. v. Graham-Field, Inc.*, 1997 U.S. Dist. LEXIS 4457, at *23, No. 96 Civ. 3839 (S.D.N.Y. Apr. 9, 1997); *Winner Int'l v. Kryptonite Corp.*, No. 95 Civ. 247, 1996 U.S. Dist. LEXIS 2182, at *10

(S.D.N.Y. Feb. 27, 1996) ("As *Winner* does not allege that *Kryptonite*'s conduct interfered with its business relationship with any specific party, it cannot establish the elements necessary for this tort . . . ."). Further, the relationship must be in existence at the time of the interference. *See Minnesota Mining*, 1997 U.S. Dist. LEXIS 4457, at *23 ("A claim for interference with advantageous business relationships must specify some particular, existing business relationship through which plaintiff would have done business but for the allegedly tortious behavior.") (citations omitted).

That interference must be "direct interference with a third party, that is, 'the defendant must direct some activities towards the third party and convince the third party not to enter into a business relationship with the plaintiff.'" *Black Radio Network, Inc. v. NYNEX Corp.*, No. 96 Civ. 4138, 2000 U.S. Dist. LEXIS 594, at *13-14 (S.D.N.Y. Jan. 25, 2000) (quoting *Fonar Corp. v. Magnetic Resonance Plus, Inc.*, 957 F. Supp. 477, 482 (S.D.N.Y. 1997) (citing *G.K.A. Beverage Corp. v. Honickman*, 55 F.3d 762 (2d Cir.), cert. denied, 516 U.S. 944, 116 S. Ct. 381, 133 L. Ed. 2d 304 (1995)); *see also Piccoli*, 19 F. Supp. 2d at 167-68. Moreover, "as a general rule, the defendant's conduct must amount to a crime or an independent tort" because "conduct that is not criminal or tortious will generally be 'lawful' and thus insufficiently 'culpable' to create liability for interference with prospective contracts or other non-binding economic relations." *Carvel Corp. v. Noonan*, 3 N.Y.3d 182, 190, 818 N.E.2d 1100, 1103, 785 N.Y.S.2d 359 (2004); *see also Treppel v. Biovail Corp.*, No. 03 Civ. 3002, 2005 U.S. Dist. LEXIS 2737, at *14 (S.D.N.Y. Feb. 22, 2005 (Leisure, J.); (noting that the general rule following

Carvel is that defendant's conduct must amount to a crime or an independent tort); *Rome Ambulatory Surgical Ctr., LLC v. Rome Mem'l Hosp., Inc.*, 349 F. Supp. 2d 389, 423 (N.D.N.Y. 2004) (same). The only recognized exception to the rule applies where a defendant engages in conduct "for the sole purpose of inflicting intentional harm on plaintiffs." *Carvel*, 3 N.Y.3d at 190, 818 N.E.2d at 1103 (quotation omitted); *see also Carvel*, 350 F.3d at 17-19 (providing that plaintiff may establish this element of the tort by showing either that defendant used "wrongful means" or acted "solely out of malice").

Here, plaintiff cannot claim tortious interference with its relationship with RBC because defendants' alleged tortious action directed toward the third party, RBC, did not convince RBC to avoid business relationships with plaintiff; RBC very much wished to continue its relationship with plaintiff. Rather, it was plaintiff who refused to engage in future transactions with RBC. Defendants cannot be held responsible for plaintiff's decision to terminate its relationship with RBC. Plaintiff attempt to warp the law to suit its particular case is of no avail and its claim must be summarily dismissed with prejudice.

III. Jurisdiction

Based on the above, the only issue of material fact as to plaintiff's claims resides in whether the Schneiders and RBC intended that Highland be a third party beneficiary to the alleged Schneider / RBC oral contract. All of plaintiff's other claims are dismissed on the merits, with prejudice. Moreover, because the underlying

contract falls within the statute of frauds, plaintiff's remaining claim as third party beneficiary is only enforceable up to $ 5000. *See* N.Y. U.C.C. § 1-206. Thus, plaintiff's claim does not satisfy the $ 75,000 statutory requirement for diversity jurisdiction and this Court is required to *sua sponte* dismiss the action. 28 U.S.C. § 1332(a); Fed. R. Civ. P. 12(h)(3); *see Scherer v. Equitable Life Assur. Soc'y of the United States*, 347 F.3d 394, 397 (2d Cir. 2003).

Because the Schneiders and RBC are not completely diverse parties,[23] the Court cannot exercise original jurisdiction over the remaining third party complaint and counter-claims. 28 U.S.C. § 1332(a). Without jurisdiction over the original claim, the Court may decline to exercise supplemental jurisdiction over the third-party complaint. 28 U.S.C. § 1367(c)(3). In exercising its discretion, the Court should not exercise supplemental jurisdiction where the original claims are dismissed for lack of jurisdiction. *See Nowak v. Ironworkers Local 6 Pension Fund*, 81 F.3d 1182, 1187-88 (2d Cir. 1996) (dealing with a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)). Here, the claims are dismissed both on the merits and for want of jurisdiction, a scenario not wholly encompassed by Nowak. There, the district court premised its decision to retain supplemental jurisdiction over the state claims rather than remand to state court on judicial economy by stating: "to now require much of this court's efforts in acquainting itself with the facts and issues of the case

23. Leonard Schneider is a resident of Florida, while Leslie, Scott and Susan Schneider are residents of New York. RBC is a New York corporation. Supra, Background Part I.

to be substantially replicated in state court would not serve the interests of judicial economy, convenience, and fairness that are central to the exercise of supplemental jurisdiction." *Id.* at 1187. This Court is not faced with such a dilemma here, and it is not foregone that RBC and the Schneiders would pursue their third party claims after this Court dismisses plaintiff's action. While this Court is well-steeped in the facts of the case, the third-party claims are, for the most part, legally divergent and would require assessments independent of those engaged in above. Therefore, the Court finds that the best exercise of judicial discretion here is to dismiss the remaining action for want of jurisdiction.

CONCLUSION

For the reasons stated above, plaintiff's complaint counts one through six are dismissed on the merits pursuant to Federal Rules of Civil Procedure 12(c) and 56. Plaintiff's complaint count seven is dismissed for want of subject matter jurisdiction pursuant to 28 U.S.C. § 1332(a) and Federal Rule of Civil Procedure 12(b)(1). The Court declines to exercise supplemental jurisdiction over the third-party complaints of the Schneiders and RBC, pursuant to 28 U.S.C. § 1367(c)(3). Accordingly, the entire above-captioned action is dismissed as to all parties.

SO ORDERED.
New York, New York
July 25, 2005
Peter K. Leisure, U.S.D.J.

APPENDIX E — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DECIDED AUGUST 15, 2006

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket Nos. 05-4729-cv (L), 05-4869-cv (XAP)

460 F.3d 308; 2006 U.S. App. LEXIS 20993; 60 U.C.C. Rep. Serv. 2d (Callaghan) 837

HIGHLAND CAPITAL MANAGEMENT LP,

Plaintiff-Appellant-Cross-Appellee,

-v.-

LEONARD SCHNEIDER, LESLIE SCHNEIDER, SCOTT SCHNEIDER, AND SUSAN SCHNEIDER,

Defendants-Third-Party-Plaintiffs-Counter Defendants-Appellees-Cross-Appellants,

JENKENS & GILCHRIST PARKER CHAPIN LLP,

Defendant-Appellee,

RBC DOMINION SECURITIES CORP.,

Third-Party-Defendant-Counter-Claimant-Cross-Appellee.

Appendix E

June 15, 2006, Argued
August 15, 2006, Decided

JUDGES: Before: WINTER and RAGGI, Circuit Judges, and CROTTY, District Judge.[1]

OPINION BY: Paul A. Crotty

OPINION

CROTTY, *District Judge*:

Plaintiff-Appellant Highland Capital Management LP ("Highland") appeals from a judgment of the United States District Court for the Southern District of New York (Peter J. Leisure, *Judge*) dismissing counts one through seven of its complaint against Defendants-Appellees Leonard Schneider, Leslie Schneider, Scott Schneider, and Susan Schneider (collectively, the "Schneiders"). While Highland appeals the district court's dismissal of all counts, we dispose of counts three through six in a separate summary order. This decision deals only with the narrow question of whether the promissory notes issued by McNaughton Apparel Group, Inc. ("McNaughton") to the Schneiders fall within the definition of a "security" in Section 8-102(a)(15) of the New York Uniform Commercial Code ("U.C.C."), and therefore are exempt from application of the New York statute of frauds, N.Y. U.C.C. § 1-206(1). The district court found that the notes were not

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1. The Honorable Paul A. Crotty, United States District Judge for the Southern District of New York, sitting by designation.

"securities." Recognizing the lack of clarity in New York law regarding what constitutes a "security" under Section 8-102(a)(15) of the New York U.C.C., and the importance of this question to the financial community, we certify the question to the New York Court of Appeals. We retain jurisdiction over counts one, two and seven of Highland's Third Amended Complaint-Highland's three contract-based claims-so that, upon receipt of the New York Court of Appeals' answer, we may rule on the remainder of Highland's appeal.

BACKGROUND

The underlying facts of the dispute between Highland and the Schneiders are set out in great detail in the district court's Opinion and Order dated July 25, 2005. *See Highland Capital Mgmt. L.P. v. Schneider*, No. 02-8098, 2005 U.S. Dist. LEXIS 14912, at *8-28 (S.D.N.Y. July 26, 2005). Since we assume familiarity with the district court's decision, we provide here only a brief summary of the facts relevant to the question of whether the subject promissory notes are securities under the New York U.C.C. Like the district court, we construe the facts in the light most favorable to plaintiff, although we recognize the Schneiders' sharp disagreement with many of the allegations advanced.

A. Issuance of the Promissory Notes to the Schneiders

The Schneider defendants owned and operated two apparel companies, Jeri-Jo Knitwear and Jamie Scott, Inc. (collectively "Jeri-Jo"). On April 15, 1998, the

Schneiders sold Jeri-Jo to McNaughton. McNaughton paid $ 55 million, assumed debt worth $ 10.9 million, and promised to pay an earn-out payment based on Jeri-Jo's performance over the next two years.

Owing to Jeri-Jo's success in this two-year period, McNaughton owed the Schneiders approximately $ 190 million in earn-out profits. Originally, the earn-out payments were to be in cash or stock. As a result of McNaughton's poor financial condition at the time the earn-out payments came due, however, McNaughton and the Schneiders agreed that part of the payment would be issued in the form of promissory notes. The parties negotiated and agreed to a total earn-out payment of $ 161 million, with the Schneiders receiving the following combination of cash, stocks and notes: (1) $ 95 million in cash upfront; (2) $ 30 million in cash after McNaughton received new financing; (3) $ 26 million in McNaughton common stock; and (4) $ 10 million in four three-year promissory notes.[2]

As the deadline for the $ 30 million cash payment approached in November 2000, McNaughton asked for an extension until April 2001. The Schneiders declined McNaughton's request for an extension, and instead accepted four additional promissory notes with a total face value of $ 59 million in lieu of the $ 30 million cash

2. This first set of promissory notes was issued on August 29, 2000. Leonard Schneider received a note worth $ 4 million, Leslie Schneider and Susan Schneider each received notes worth $ 2.4 million, and Scott Schneider received a note worth $ 1.2 million, for a total of $ 10 million.

payment. This second set of promissory notes was issued on December 1, 2000.[3]

All eight notes were stamped "subordinated promissory note," as they were subordinate to senior creditors and were convertible to stock if McNaughton ever dissolved.[4] The Notes were payable to the individual Schneider to whom the money was owed, not to a generic bearer, but were fully transferrable as long as McNaughton complied with the registration requirements of the Securities Act of 1933.[5] The Schneiders' ability to find a suitable buyer for the notes

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3. Leonard Schneider received a note worth $ 23.6 million, Leslie Schneider and Susan Schneider each received notes worth $ 14,160,000, and Scott Schneider received a note worth $ 7,080,000, for a total face value of $ 59 million.

4. Because of these qualities, Highland characterizes the notes as "convertible subordinated debentures." *See* Appellant's Br. 5. On summary judgment, the district court rejected this characterization, however, stating that the notes were not identical to debentures because they were not issued "for the purpose of financing and investment." *See* 2005 U.S. Dist. LEXIS 14912, at *11, 49 n.19. Given that the promissory notes were issued in exchange for money otherwise owed, money that McNaughton got to keep and use for financing and investment purposes, the district court's limitation may not be appropriate.

5. Each Note contained at the top the following restrictive legend:

> THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. IT MAY NOT BE TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE

(Cont'd)

was limited, however, by the fact that all of the promissory notes were considered high-risk debt due to the uncertainty about McNaughton's ability to pay them off. All notes indicated that they were to be "governed by and construed in accordance with" New York law.

B. Potential Sale of Promissory Notes by the Schneiders

In late 2000 and early 2001, the Schneiders decided to price the notes. They engaged Glen Rauch, a broker-dealer acting through his company Glen Rauch Securities, Inc. ("Rauch"), for this purpose. Rauch, in turn, engaged RBC Dominion Securities Corp. ("RBC") as an agent and exclusive broker for the purpose of marketing the notes. RBC was to act as a "riskless principal" in the deal, meaning that RBC agreed it would purchase the notes from the Schneiders (through Rauch) and then "flip" the notes by selling them to a third-party purchaser at a premium. As a "riskless principal," RBC would not actually "purchase" the notes until the third-party end-purchaser was already lined up and ready to complete the final purchase, so that

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(Cont'd)

> REGISTRATION STATEMENT UNDER SUCH ACT OR AN OPINION OF COUNSEL TO THE MAKER [MCNAUGHTON] THAT SUCH REGISTRATION IS NOT REQUIRED.

(J.A. A-520, A-532, A-544, A-558, A-569, A-580, A-591, A-602.)

RBC would not assume any risk in the transaction. In this sense, RBC would be both a seller and a buyer in the deal, an arrangement common in the financial world.

Sometime in January 2001, RBC found a buyer for the notes, Plaintiff Highland, and negotiations between RBC and Highland over price ensued. Highland allegedly agreed to purchase $ 45.4 million worth of the notes at a price of 52.5 cents on the dollar.[6] On March 14, 2001, Rauch allegedly informed RBC that the Schneiders had agreed to the transactions, and the parties entered an oral agreement to carry out the trade.[7] As is customary in the financial industry, these negotiations were telephonically recorded, rather than memorialized on paper. These recordings allegedly reflect that throughout the course of negotiations, all parties considered the notes to be "tradeable securities,"

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6. The $ 45.4 million represents 7 out of 8 of the notes. Fidelity, an unrelated company, agreed to purchase the remaining Note. Under the agreement, RBC would buy the notes from the Schneiders at 51 cents on the dollar and Highland would then buy the notes from RBC at 52.5 cents on the dollar. This spread of 1.5 cents on the dollar was to be RBC's compensation for the deal.

7. The Schneiders never spoke directly to Highland about the trade. The oral agreement, if it was actually reached, was formed between the Schneiders and Highland through Rauch and RBC as intermediaries. The Schneiders allege that they never agreed to the trade on March 14, 2001, but RBC and Highland claim that, in an unrecorded conversation on March 14, 2001, Rauch confirmed a sale of $ 45.4 million in notes to Highland for 51 cents on the dollar.

which could be sold only by a broker-dealer with an applicable securities license to a buyer who qualified as an "accredited investor."

On or about March 9, 2001, the Schneiders allegedly learned that Jones Apparel Group ("Jones") intended to acquire McNaughton, an acquisition that would require the eight notes to be paid in full. Based on this information, the Schneiders decided not to sell the notes, and therefore refused to settle the trade with Highland. Three weeks later, Jones's acquisition of McNaughton was announced to the public, and the Schneiders' notes were paid off in full.[8]

C. Procedural History

On October 18, 2001, Highland brought suit against the Schneiders in Texas state court for breach of contract, tortious interference with contractual relations, and third-party beneficiary breach of contract.[9]

8. The Schneiders received $ 69 million as a result of the payout. If the Schneiders had settled the trade with Highland and Fidelity, the Schneiders would have received only $ 35.2 million dollars ($ 0.51 cents on the dollar).

9. Highland's claim for third-party beneficiary breach of contract is premised on a theory that the Schneiders and RBC entered into an agreement, through Rauch, for the benefit of Highland. Therefore, the Schneiders' breach of its agreement with RBC injured Highland. RBC intended to act as a "riskless principal" in the sale, purchasing the notes from the Schneiders and then immediately reselling them to third-party purchasers (in this case, Highland and Fidelity) at a premium.

The Schneiders removed the case to the Northern District of Texas based on diversity of citizenship under 28 U.S.C. § 1332(a), and the case was later transferred to the Southern District of New York. After transfer, the Schneiders answered, denying that they ever made an agreement with Highland to sell the notes and asserting, among other things, a defense of the statute of frauds.

At the close of discovery, the Schneiders moved for summary judgment and judgment on the pleadings to dismiss Highland's claims against them. The district court granted Defendants' motions for summary judgment and judgment on the pleadings, dismissing counts one through six of Highland's complaint on the merits pursuant to Federal Rules of Civil Procedure 12(c) and 56, and dismissing count seven of Highland's complaint for lack of subject matter jurisdiction pursuant to 28 U.S.C. § 1332(a) and Federal Rule of Civil Procedure 12(b)(1). Highland now appeals.

DISCUSSION

I. ISSUE RAISED IN THIS APPEAL

While Highland raises a number of issues on appeal, this decision addresses only the narrow and highly specific issue of whether the eight promissory notes issued by McNaughton to the Schneiders are "securities" as the term is defined in Section 8-102(a)(15) of the New York U.C.C. This question is directly relevant to our review on appeal, as it determines

whether the alleged oral agreement to sell the notes in March 2001 is subject to the New York statute of frauds, N.Y. U.C.C. § 1-206(1).[10] If the statute of frauds applies, then this court may well lack subject matter jurisdiction to review the district court's dismissal of Highland's contract-based claims. If the statute of frauds does not apply, then this Court would have to address the serious possibility that the district court's dismissal of these claims was in error.

A. Section 8-102(a)(15) of the New York Uniform Commercial Code

The current version of the New York U.C.C. defines a "security" as:

> [A]n obligation of an issuer or a share, participation, or other interest in an issuer . . .

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10. The New York Uniform Commercial Code requires that any contract for the sale of personal property over five thousand dollars be in writing, "signed by the party against whom enforcement is sought or by his authorized agent." N.Y. U.C.C. § 1-206(1). Because "the statute of frauds is unsuited to the realities of the securities business," the sale of "securities" is exempt from the writing requirement set forth in Section 1-206(1). See N.Y. U.C.C. § 8-113(a) & cmt. The provision states: "[A] contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought." N.Y. U.C.C. § 8-113(a). Therefore, if the Schneiders' promissory notes are "securities," then an oral agreement to sell the notes would be enforceable, potentially rendering the district court's grant of summary judgment for defendants erroneous.

> (i) which is represented by a security certificate in bearer or registered form, or the transfer of which *may be* registered upon books maintained for that purpose by or on behalf of the issuer;
>
> (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
>
> (iii) which . . . is, or is of a type, dealt in or traded on securities exchanges or securities markets . . . .

N.Y. U.C.C. § 8-102(a)(15) (emphasis added).

B. The District Court's Analysis of the Schneiders' Notes Under Section 8-102(15)

The district court held that the Schneiders' promissory notes were not "securities" under Section 8-102(a)(15) of the New York U.C.C. because the notes were neither "represented by a security certificate in bearer or registered form," nor "registered upon books maintained for [the purpose of recording transfer] by or on behalf of the issuer," as required under subsection (i) of the definition. The district court said the notes were "not represented by a certificate," because they were "signed by the maker, McNaughton, and represented as a note of payment due." *See Highland*, 2005 U.S. Dist. LEXIS 14912, at *44.

Neither the plain language of the statute nor the accompanying commentary are clear about what constitutes a "certificate" for U.C.C. purposes. The New York U.C.C. defines a "security certificate" in a rather circular fashion, as "a certificate representing a security." N.Y. U.C.C. § 8-102(16). There are two possible meanings: either "certificate" refers to a specialized document, e.g., the paper certificates that have traditionally been used to represent stocks, or "certificate" refers to any paper used to embody the underlying intangible interest. *See* N.Y. U.C.C. § 8-102(16) & cmt n.16. If the term "certificate" refers to the latter, then the promissory notes, each of which is evidenced by a twelve-page writing, would meet the definition of "certificate"; if the term "certificate" refers to the former, i.e., a specialized document such as a stock certificate, then it is correct to find that the Schneiders' notes are "not represented by a certificate." There is no New York case law clarifying what constitutes a "certificate" for purposes of Section 8-102.

Assuming the district court is correct that the Schneiders' notes are "not represented by a certificate," then the notes must be analyzed under the second clause of subsection (i), which addresses "uncertificated securities." *See* N.Y. U.C.C. § 8-102 cmt. n.15 (explaining that subsection (i) is structured in the alternative, so that an interest or obligation is a "security" if "the issuer *either* maintains transfer books *or* the obligation or interest is represented by a certificate in bearer or registered form" (emphasis added)); *see also* N.Y. U.C.C. § 8-102(a)(18) (defining an "uncertificated security" as

"a security that is not represented by a certificate"). The second clause of subsection (i) provides that an uncertificated obligation or interest is a "security" only if "the transfer of [the obligation or interest] *may be* registered upon books maintained for that purpose by or on behalf of the issuer." N.Y. U.C.C. § 8-102(a)(15)(i) (emphasis added). Applying this language, the district court found that "there [was] no evidence that the transfer is registered on 'books maintained for that purpose by or on behalf of the issuer,'" and therefore the notes could not be "securities" as a matter of law. *See Highland*, 2005 U.S. Dist. LEXIS 14912, at *44-46.

We are not certain that the district court's analysis was correct. Subsection (i) does not require that transfer of the obligation or interest actually be registered on books maintained for that purpose, as the district court's opinion suggests, but only that they *may be* registered on such books. Therefore, we believe that the proper inquiry is whether the notes *could have been* registered on transfer books maintained by McNaughton, not whether they were registered on transfer books at the time of the litigation.

Moreover, some record evidence suggests that the Schneiders' notes may have been registered on transfer books. Specifically, each note contained a restrictive legend providing that the notes could "not be transferred in the absence of an effective registration statement" or an "opinion of counsel to the maker that such registration is not required." (J.A. A-520, A-532, A-544, A-558, A-569, A-580, A-591, A-602.) Registration

for the purpose of the Securities Act of 1933, as the restrictive legend requires,[11] is not the same as registration on the books of the corporation for purposes of transfer, as the New York U.C.C. definition of a "security" requires. The existence of the restrictive legend suggests, however, that McNaughton would have had to monitor the notes in some manner, in order to ensure compliance with the registration requirements indicated in the legend. Such monitoring is usually done through the use of transfer books. Thus, even if McNaughton chose not to maintain separate books to monitor the transfer of the Schneiders' notes, McNaughton could have—and perhaps should have—maintained such books.

Further, each Note required that McNaughton make substantial quarterly principal payments and monthly interest payments at 9-3/4 % to each of the holders. These payments were recorded on the books of the corporation. As Highland points out, the continued existence of these payment obligations suggests that McNaughton would have had to record the transfer of the notes on special transfer books in order to identify the holders to whom these payments were due. Thus, transfer of the promissory notes may have been registered upon books maintained for that purpose by or on behalf of McNaughton.

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11. When McNaughton issued the promissory notes to the Schneiders, the issuance was reported to the SEC, and an appropriate press release was published announcing the issuance to the public. While this is done for SEC purposes, without any consideration of the New York U.C.C., it suggests that McNaughton regarded the notes as "securities."

The drafters' use of the words "may be" is explained perhaps by Section 8-401 of the New York U.C.C., entitled "Duty of Issuer to Register Transfer." Section 8-401 provides that "[i]f a certificated security in registered form is presented to an issuer with a request to register transfer or an instruction is presented to an issuer with a request to register transfer of an uncertificated security, the issuer" must register the transfer as long as certain requirements are met. Reading subsection (i) of Section 8-102(a)(15) in light of Section 8-401, the phrase "*may be* registered" in Section 8-102(15)(i) likely means that the obligation or interest is of the type that Section 8-401 requires the issuer to register, if instructed to do so. Thus, contrary to the Schneiders' suggestion in their opposition brief, giving effect to the term "may be" does not necessarily mean that it will be "limitless" in scope. See Appellee's Br. 43. We recognize, however, that neither the New York U.C.C. nor the New York courts have defined the contours of subsection (i), and therefore whether the Schneiders' notes meet the first prong of the tripartite test for a "security" under the New York U.C.C. remains unresolved.

Since the District Court found that the notes do not meet the first prong of Section 8-102(a)(15), it did not analyze whether the notes meet the second and third prongs. We believe that they do. The question of whether the Schneiders' notes were "of a class or series" is answered by the terms of the notes themselves. In total, McNaughton issued eight notes: notes in August 2000, and 4 notes in December 2000. As such, the notes are

clearly divisible into "a class or series," so the second prong of Section 8-102(15) is satisfied. *See, e.g., Baker v. Gotz*, 387 F. Supp. 1381, 1390 (D. Del. 1975) (finding that a note was "patently 'one of a class or series'" where six notes were issued, five in the amount of 4,000,000 Swiss francs and the sixth in the amount of 5,360,000).

While the Schneiders' notes were not actually traded on a securities exchange or securities market, they were "of a type" dealt in securities exchanges or markets. *See, e.g., In re Domestic Fuel Corp.*, 70 B.R. 455, 462 (Bankr. S.D.N.Y. 1987) (noting that "whether or not there is a market for the particular instrument is not the controlling factor, if the instrument is 'of a type commonly dealt in upon securities exchanges or markets'" (*quoting* Practice Commentary accompanying Section 8-102)); *Baker v. Gotz*, 387 F. Supp. at 1390 (same). Support for this position may be found in the record itself. In a recorded conversation between James Alterbaum, a partner at Jenkins Gilchrist Parker Chapin, the law firm representing the Schneiders, and Ken Ambrecht, a broker at RBC, Alterbaum allegedly referred to the notes as "freely tradeable securities." (J.A. A-914.) Glen Rauch, a broker-dealer, also referred to the notes as "tradeable securities" and stated that he "wouldn't even think of" trading without an applicable securities license. (J.A. A-914, A-1422 to A-1427.) Moreover, the fact that the Schneiders retained securities professionals to sell the notes, and these professionals found willing buyers for the notes, demonstrates that the notes are "of the type dealt in or traded on securities . . . markets." Therefore, the third prong of Section 8-102(a)(15) is satisfied.

II. CERTIFICATION TO THE NEW YORK COURT OF APPEALS

The parties do not dispute that New York law governs this diversity action. We review de novo the district court's interpretation of New York law. *See Salve Regina Coll. v. Russell*, 499 U.S. 225, 231, 111 S. Ct. 1217, 113 L. Ed. 2d 190 (1991). Where, as here, the New York Court of Appeals has not yet spoken on the issue before the Court, we must either (1) predict how the New York Court of Appeals would resolve the question, or (2) certify the question to the New York Court of Appeals for a definitive resolution. *See* 2d Cir. R. § 0.27 (permitting us to certify "to the highest court of a state an unsettled and significant question of state law that will control the outcome of a case"); N.Y. Comp. Codes R. & Regs. tit 22,§ 500.27(a) (authorizing certification of "determinative questions of New York law . . . for which no controlling precedent of the [New York] Court of Appeals exists"); *Morris v. Schroder Capital Mgmt. Int'l*, 445 F.3d 525, 530-31 (2d Cir. 2006); *DiBella v. Hopkins*, 403 F.3d 102, 111 (2d Cir. 2005).

We resort to certification sparingly, mindful that "it is our job to predict how the [New York Court of Appeals] would decide the issues before us." *See DiBella*, 403 F.3d at 111 (quoting *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363, 370 (2d Cir. 1999)). Therefore, we do not certify questions of law "where sufficient precedents exist for use to make [a] determination." *Id.* Where a "statute's plain language does not indicate the answer," however, certification is permissible. *Riordan*

v. Nationwide Mut. Fire Ins. Co., 977 F.2d 47, 51 (2d Cir. 1992); *accord McGrath v. Toys "R" Us, Inc.*, 356 F.3d 246, 250 (2d Cir. 2004). In determining whether to certify a question, we consider three primary issues: "(1) the absence of authoritative state court interpretations of the state statute; (2) the importance of the issue to the state, and whether the question implicates issues of state public policy; and (3) the capacity of certification to resolve the litigation." *Morris*, 445 F.3d at 531 (internal citations and quotation marks omitted). After careful consideration of these factors, we believe that certification is appropriate in this case.

A. Is this an Unsettled Area of New York Law?

1. New York Court of Appeals

While there is "scant caselaw" emanating from the New York courts on what constitutes a "security" under Section 8-102 of the New York U.C.C., we are not entirely without guidance. The New York Court of Appeals has stated that "[A]rticle 8 of the Uniform Commercial Code . . . governs stocks, bonds and other evidences of indebtedness." *Vigilant Ins. Co. of Am. v. Hous. Auth. of El Paso*, 87 N.Y.2d 36, 43, 660 N.E.2d 1121, 637 N.Y.S.2d 342 (1995). Other than reciting the language of Section 8-102(15), however, the Court of Appeals did not elaborate in *Vigilant Insurance* on what "other evidences of indebtedness" constitute "securities" for purposes of the New York U.C.C. The Court of Appeals has never addressed the specific question of whether promissory notes are—or in certain

defined circumstances can be—"securities" under the New York U.C.C. Therefore, there is no controlling precedent on this issue.

2. Lower New York courts

The Appellate Division, First Department has recognized that promissory notes are undoubtedly "securities" for purposes of the Martin Act, New York's counterpart to the Securities and Exchange Acts of 1933 and 1934. *See ALH Props. Ten, Inc. v. 306-100th St. Owners Corp.*, 191 A.D.2d 1, 9, 600 N.Y.S.2d 443 (1st Dep't 1993) (reciting the definition of a "security" for purposes of the Martin Act, N.Y. Gen. Bus. L. § 352); *see also* N.Y. Gen. Bus. L. § 352 (including in the definition of a "security" any "note" or "evidence of indebtedness"); 15 U.S.C. § 77b(1) (same). The First Department cautioned, however, that the statutory definition of "security" contained in Section 8-102(15) of the New York U.C.C. is not identical to the term "security" as used in the context of federal and state securities regulation or other New York statutes:

> "In General Business law, § 359-m (f), the 'Uniform Act for Simplification of Fiduciary Security Transfers', the term ["security"] is stated to include 'any share of stock, bond, debenture, note or other security issued by a corporation which is registered as to ownership on the books of the corporation'.
>
> "The New York 'Blue Sky Law' uses the term to cover 'stocks, bonds, notes, evidences of

> interest or indebtedness or other securities, including oil and mineral deeds or leases and any interest therein, sold or transferred in whole or in part to the purchaser where the same do not effect a transfer of the title in fee simple to the land, or negotiable documents of title, or foreign currency orders, calls or options therefor . . .' General Business Law, § 352(1)." (McKinney's Cons Laws of NY, Book 62 A 1/2, UCC 8-102, at 129.) The New York Annotations conclude by noting that the "Code definition, applicable to Article 8, is broader than the definition in General Business Law, § 359-m (f), narrower than that in General Business Law, § 352(1), and more nearly in accord with the definition found in Matter of Waldstein, 160 Misc. 763, 766-67, 291 N.Y.S. 697, 700 (1936) ('instruments for the payment of money, or evidencing title or equity, with or without some collateral obligation, and which are commonly dealt in for the purpose of financing and investment'.)" (*Ibid.*)

Id. at 9; *accord Gardner v. Lefkowitz*, 97 Misc. 2d 806, 812, 412 N.Y.S.2d 740 (N.Y. Sup. Ct., N.Y. Co. 1978). The definition of a "security" articulated in In re Waldstein, and adopted by the First Department in ALH Properties as the definition of a "security" for purposes of Article 8 of the New York U.C.C., is broad enough to encompass the Schneiders' promissory notes. Similarly, the New York County Supreme Court, Appellate Term, observed

in *Cohn, Ivers & Co. v. Gross*, that "any form of instrument used for the purpose of financing and promoting enterprises, and which is designed for investment, is a security" for purposes of the New York U.C.C. *See* 56 Misc. 2d 491, 494, 289 N.Y.S.2d 301 (N.Y. App. Term, 2d & 11th Dist. 1968). A promissory note fits that definition. Other than these few cases, however, no New York have endeavored to define what constitutes a "security" for purposes of the New York U.C.C.

3. Federal courts interpreting the U.C.C.

The few federal cases on this issue support the conclusion that the U.C.C. definition of a "security" includes notes of the type held by the Schneiders. In *Baker v. Gotz*, for example, the Delaware District Court expressly held that three subordinated promissory notes issued by Delaware corporations were "securities" under Section 8-102 as it existed in both Delaware and New York at the time.[12] *See* 387 F. Supp. at 1389-90. Like the

12. The definition of a "security" contained in Section 8-102 in 1975, when *Baker v. Gotz* was decided, was as follows:

> (a) A "security" is an instrument which (i) is issued in bearer or registered form; and (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and (iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

(Cont'd)

promissory notes in our case, the notes analyzed in *Baker v. Gotz* were subordinated notes issued by large corporations and payable to specific entities named on the notes. *See id.* at 1385-86. While the court in *Baker v. Gotz* reviewed the notes to determine if they were attachable in Delaware, rather than to determine if an oral agreement for sale of the notes was barred by the statute of frauds, there is no indication in the U.C.C. or the case law that the definition of "securities" would differ for these two purposes.

Judge Cabranes's decision in *S.N. Phelps & Co. v. Prudential Insurance Company of America*, No. 91 Civ. 451, slip. op (D. Conn. Nov. 22, 1991), is also instructive.[13] The question in S.N. Phelps was "whether SNP and

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(Cont'd)

Baker v. Gotz, 387 F. Supp. at 1389. Both Delaware and New York had adopted identical language.

This definition is almost identical to the definition set forth in the current version of Section 8-102, except subsection (i) now includes additional language. Under this new language, an obligation or interest does not need to be "in bearer or registered form" to be a "security," as long as it is of the type "the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer." *See* N.Y. U.C.C. § 8-102(a)(15)(i). If anything, this newly added language appears to broaden the definition of a "security," thereby suggesting that the finding of the Delaware court in *Baker v. Gotz* that the promissory notes were "securities" under Section 8-102 would apply with equal force today.

13. A copy of this decision is found in the Joint Appendix, vol. 1, at A-485 to A-519.

Prudential entered into a binding oral agreement . . . for the purchase by SNP and the sale by Prudential of $ 75 million (face amount) 12.75% Senior Subordinated Notes."[14] Slip op. at 1. Applying the New York version of the U.C.C., Judge Cabranes treated the notes as "securities."[15] *See id.* at 24. While Judge Cabranes held that SNP's alleged oral contract for the sale of the notes was barred by the statute of frauds, this holding was based on Section 8-319, the then-existing statute of frauds governing the purchase and sale of securities. Section 8-319 was repealed in 1997, and replaced by Section 8-113, the provision at issue in this case. *See* N.Y. U.C.C. § 8-113 note & cmt. Thus, any oral agreement previously unenforceable by the Section 8-319 statute of frauds now falls within Section 8-113's exemption to the statute of frauds. Applying Judge Cabranes's logic to the present case, then, the Schneiders' notes would be "securities" exempted from the statute of frauds by Section 8-113.

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14 The only difference between the Schneider notes and the S.N. Phelps notes appears to be that the Schneider notes were issued to cover a debt already owed for the purchase of the Schneiders' company, while S.N. Phelps notes were purchased from the issuer in exchange for a cash payment by the defendant holder. The classification of a financial instrument should not turn on whether the holder of the instrument paid in cash or in kind (i.e.., by handing over a business), however, and therefore the notes are, for all relevant purposes, identical.

15. Interestingly, Judge Cabranes assumed the notes were "securities" under the New York U.C.C. without any discussion of the matter.

4. The district court's treatment of the case law

The district court read *ALH Properties* and *Cohn, Ivers* as requiring that "the instruments alleged to be securities represent an investment in the issuing company." *Highland*, 2005 U.S. Dist. LEXIS 14912, at *47-48. Since the debt evidenced by the Schneiders' notes "did not finance McNaughton's company analogous to a stock share," the Court concluded that the Schneiders' notes were not investment instruments. *Id.* The New York courts have yet to speak on whether promissory notes of the type at issue in this case are properly seen as "investments," and therefore "securities" for U.C.C. purposes. Other sources suggest that "investment" has a broader meaning than the district court's finding. The dictionary defines "investment" as: "[T]he commitment of funds with a view to minimizing risk and safeguarding capital while earning a return." Webster's Third New Int'l Dictionary 1190 (2002). The Schneiders' promissory notes fit comfortably within this definition. In fact, promissory notes are often used as a "medium for investment." *See, e.g.*, Circular Letter No. 17 (2000), May 22, 2000, N.Y. Dep't of Insurance (noting that promissory notes are often sold by licensed insurance agents as a form of investment), at www.ins.state.ny.us/cl00_17.htm; Broken Promises: Promissory Note Fraud, U.S. Securities & Exchange Commission (explaining that "promissory notes can be legitimate investments"), available at www.sec.gov/investor/pubs/promise.htm. The Schneiders held their notes as any other secure

investment, collecting monthly interest payments on each note and expecting return of the principal over time. Further, the notes were marketed to third-party purchasers, i.e., Highland and Fidelty, as a medium for investment, just like any other debt instrument.

Moreover, it is clear from the record that McNaughton, a publicly traded company, could have paid the Schneiders in its stock rather than notes. If so, the Schneiders would clearly hold securities. The fact that they took notes instead of stocks should not change the analysis. There is no good reason why notes issued in lieu of stock should not be considered "investment instruments," whereas stock issued by a company to finance the same transactions are "investment instruments." To hold otherwise exalts form over function, and ill serves the needs of the financial marketplace.

B. Is This an Important Issue of New York Law and Policy?

The unresolved issue of whether promissory notes constitute "securities" for purposes of Article 8 of the New York U.C.C. raises legal and policy issues that we believe are best resolved by the New York Court of Appeals. The lack of congruence between the regulatory definition of a security and the U.C.C. definition of a "security" creates confusion and uncertainty within the financial world. As previously noted, promissory notes like the ones in this case are undoubtedly "securities" for purposes of the Martin Act and the Securities and

Exchange Acts of 1933 and 1934. *See* 15 U.S.C. § 77b(1); N.Y. Gen. Bus. Law § 352(1). But the few New York cases that have addressed the issue have said that the definition of a "security" for purposes of the New York U.C.C. is more narrow than the definition of a "security" for federal and state regulatory purposes. *See, e.g., ALH Props Ten v. 306-100th St. Owners Corp.*, 191 A.D.2d 1, 9-10, 600 N.Y.S.2d 443. These strained distinctions create problems in the marketplace. Understanding the notes to be "securities," brokers and other industry professionals are not structuring their deals differently to accommodate the more narrow U.C.C. definition. As a result, the rights and duties of buyers and sellers in the marketplace differ depending upon what sort of financial asset they are trading, even when these assets are being sold in the same manner, by the same clients, through the same brokers. Imposing such uncertainty upon the financial community risks deterring the trading of promissory notes in financial markets, thereby restricting the free flow of capital. This is an undesirable result anywhere, but particularly here in New York, the financial capital.

New York sources offer differing advice on how to resolve this unintended discord. The legislative notes accompanying the U.C.C. suggest that the courts should expand the definition of "security" to include promissory notes. Section 1-102 of the U.C.C. mandates that the U.C.C. is to be "liberally construed and applied to promote its underlying purposes and policies." N.Y. U.C.C. § 1-102(1). The three primary purposes and policies of the New York U.C.C. are: "(a) to simplify,

clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; and (c) to make uniform the law among the various jurisdictions." N.Y. U.C.C. § 1-102(2)(a)-(c). The official comment accompanying Section 1-102 makes clear:

> This Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices. However, the proper construction of the Act requires that its interpretation and application be limited to its reason.
>
> Courts have been careful to keep broad acts from being hampered in their effects by later acts of limited scope. They have recognized the policies embodied in an act as applicable in reason to subject-matter which was not expressly included in the language of the act. They have done the same where reason and policy so required, even where the subject-matter had been intentionally excluded from the act in general. They have implemented a statutory policy with liberal and useful remedies not provided in the statutory text.

> They have disregarded a statutory limitation of remedy where the reason of the limitation did not apply. Nothing in this Act stands in the way of the continuance of such action by the courts.
>
> The Act should be construed in accordance with its underlying purposes and policies. The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Act as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

N.Y. U.C.C. § 1-102 cmt n.1 (internal citations omitted). Thus, "the question whether a given arrangement [fits a definition provided in the U.C.C.] should be decided not by dictionary analysis of the words of the definition taken out of context, but by considering whether it promotes the objectives of [the Article]." N.Y. U.C.C. § 8-501 cmt. n.1.

The statutory notes accompanying Article 8 further advise that Article 8 is intended "to promote uniformity with the laws of other states so that the securities market will function in such a way that it will be more stable, and so that investors, both individual and corporate, will be more secure and their rights and interests better protected." L. 1997, ch. 566, § 1. The pre-1997 comment to Section 8-102 also advised that the

term "security" is "functional rather than formal," and therefore "[t]he ambit of the definition will change as 'securities' trading practices evolve to include or exclude new property interests." *See ALH Props.*, 191 A.D.2d at 9 (quoting former comment 2 to New York U.C.C. § 8-102). On this record, there was a wealth of evidence that the Schneiders' notes were treated as "securities" by all who touched them, suggesting that perhaps the time has come to expand "the ambit of the definition" of Section 8-102(15) "security" to include the Schneiders' promissory notes.

Because the federal securities laws treat promissory notes issued by publicly traded corporations as "securities," brokers sell them in the same manner as they would other federal securities. They do not alter their selling practices to accommodate the more restricted definition of a "security" contained in the New York U.C.C. As such, financial professionals sell promissory notes in the same manner as stocks or bonds: through the use of electronic and telephonic means of record rather than through a series of writings.[16] As the U.C. C. recognized almost a decade ago:

> With the increasing use of electronic [and telephonic] means of communication, the statute of frauds is unsuited to the realities of the securities business. For securities transactions, whatever benefits a statute of frauds may play in filtering out fraudulent

16. The RBC Compliance Manual suggests that this is standard practice among securities professionals. (*See* J.A. A-330 to A-334.)

> claims are outweighed by the obstacles it places in the development of modern commercial practices in the securities business.

N.Y. U.C.C. § 8-113 cmt. This holds true regardless of whether the broker-dealer is trading a note, stock, bond or any other security. There is no good reason to deny the benefit of Section 8-113 to notes (as opposed to stocks, bonds or other securities) sold by the same industry professionals, yet this would be the inevitable result of finding that promissory notes are not "securities" under Article 8 of the New York U.C.C.

On the other hand, the U.C.C. has also cautioned that "the meaning of the statute itself must be found in its text," *see* N.Y. U.C.C. § 1-102 cmt. 2, and no New York court has yet declared that the text of Section 8-102(a)(15) includes promissory notes. The district court in this case believed that including promissory notes would expand Section 8-102(a)(15) too far. With such minimal and conflicting guidance from the New York courts, however, we believe this tension is better resolved by the New York Court of Appeals.

C. Capacity of Certification to Resolve the Litigation

The resolution of this issue determines, in large part, the outcome of this appeal, certainly with respect to the seventh claim set forth in Highland's Third Amended Complaint: whether it was a third-party beneficiary to the purported contract between the Schneiders and

RBC. The District Court found (1) that a genuine issue of material fact existed as to whether RBC and the Schneiders had entered into a contract, (2) that there was a genuine issue of material fact as to whether the contract was intended for Highland's benefit, and (3) that the purported benefit to be derived from Highland was sufficiently immediate to be protectable. *See Cal. Pub. Employees' Ret. Sys. v. Shearman & Sterling*, 95 N.Y.2d 427, 434-35, 741 N.E.2d 101, 718 N.Y.S.2d 256 (2000) (identifying the elements of a third-party beneficiary claim). Nevertheless, the district court concluded that it lacked jurisdiction to hear this claim because the applicable statute of frauds, N.Y. U.C.C. § 1-206(1), limited Highland's recovery on the third-party beneficiary claim to $ 5,000 and the claim thus failed to satisfy the $ 75,001 threshold set forth in 28 U.S.C. § 1332(a). If the notes are "securities," however, the statute of frauds does not apply. Section 8-113 clearly states: "[A] contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought." N.Y. U.C.C. § 8-113(a). Therefore, if the Schneiders' promissory notes are "securities" for purposes of the New York U.C.C., the district court's application of the statute of frauds—and hence its conclusion that Highland's recovery was limited to $ 5,000—was not correct. [17]

17. We also think it possible that resolution of the question whether the notes are securities may assist in our resolution of counts one and two of Highland's Third Amended Complaint. Accordingly, we reserve judgment on these two claims pending a response to the certified question by the New York Court of Appeals.

Appendix E

CONCLUSION

Given the "dearth of caselaw" on what constitutes a "security" under the New York version of Section 8-102(a)(15) of the New York U.C.C., and the manifest significance of the determination, we believe that certification to the New York Court of Appeals is appropriate. Accordingly, we certify the following question to the New York Court of Appeals:

> Based on this record, do the eight promissory notes issued by McNaughton Apparel Group, Inc. to the Schneiders fall within the definition of a "security" as contemplated by Section 8-102(a)(15) of the New York Uniform Commercial Code?

The New York Court of Appeals may, of course, reformulate or expand upon this question as it sees fit.

It is hereby Ordered that the Clerk of the Court transmit to the Clerk of the New York Court of Appeals a Certificate in the form attached, together with a copy of this opinion and a complete set of the briefs, appendices, and record filed by the parties in this Court. This panel will retain jurisdiction to decide the remaining issues—pertaining to counts one, two and seven of Highland's Third Amended Complaint—once we have receive an answer from the New York Court of Appeals, or once that court declines certification.

Finally, we order the parties to bear equally any fees and costs that may be requested by the New York Court of Appeals.

CERTIFICATION

The following question is hereby certified to the New York Court of Appeals pursuant to Second Circuit Local Rule § 0.27 and 22 N.Y.C.R.R. § 500.27, as ordered by the United States Court of Appeals for the Second Circuit:

> Based on this record, do the eight promissory notes issued by McNaughton Apparel Group, Inc., to the Schneiders fall within the definition of a "security" as contemplated by Section 8-102(a)(15) of the New York Uniform Commercial Code?

APPENDIX F — OPINION OF THE COURT OF APPEALS OF NEW YORK DECIDED SEPTEMBER 19, 2006

COURT OF APPEALS OF NEW YORK

2006 NY Slip Op 6482; 7 N.Y.3d 836; 857 N.E.2d 527; 824 N.Y.S.2d 206; 2006 N.Y. LEXIS 2619

HIGHLAND CAPITAL MANAGEMENT LP,

Appellant-Respondent,

v

LEONARD SCHNEIDER ET AL.,

Defendants and Third-Party Plaintiffs-Respondents-Appellants, et al., Respondent.

RBC DOMINION SECURITIES CORP.,

Third-Party Defendant-Respondent-Appellant.

No. 172

September 8, 2006, Submitted
September 19, 2006, Decided

JUDGES: Chief Judge Kaye and Judges G.B. Smith, Ciparick, Rosenblatt, Graffeo, Read and R.S. Smith concur.

Appendix F

OPINION

Certification of question by the United States Court of Appeals for the Second Circuit, pursuant to section 500.27 of the Rules of Practice of the Court of Appeals (*22 NYCRR 500.27*), accepted and the issues presented are to be considered after briefing and argument.

Concur: Chief Judge Kaye and Judges G.B. Smith, Ciparick, Rosenblatt, Graffeo, Read and R.S. Smith.

Decided September 19, 2006

APPENDIX G — OPINION OF THE COURT OF APPEALS OF NEW YORK DECIDED APRIL 3, 2007

COURT OF APPEALS OF NEW YORK

2007 NY Slip Op 27918, N.Y.3d 406, 866 N.E.2d 1020, 834 N.Y.S.2d 692; 2007 N.Y. LEXIS 613

HIGHLAND CAPITAL MANAGEMENT LP,

Appellant-Respondent,

v

LEONARD SCHNEIDER, et al.,

Respondents-Appellants and Third-Party-Plaintiffs,

JENKENS & GILCHRIST PARKER CHAPIN LLP,

Respondent.

RBC DOMINION SECURITIES CORP.,

Third-Party Defendant-Respondent.

No. 38

April 3, 2007, Decided

Appendix G

JUDGES: Opinion by Judge Read. Chief Judge Kaye and Judges Ciparick, Graffeo and Jones concur. Judge Smith dissents and votes to answer the certified question in the negative in an opinion in which Judge Pigott concurs.

OPINION BY: READ

OPINION

READ, J.:

The United States Court of Appeals for the Second Circuit has asked us whether the eight promissory notes at issue in this case are "securities" within the meaning of section 8-102 (a) (15) of the Uniform Commercial Code For the reasons that follow, we conclude that they are.

I.

In April 1998, Norton McNaughton, Inc. (subsequently, McNaughton Apparel Group, Inc.) acquired two women's apparel companies — Jeri-Jo Knitwear Inc. (owned by Leonard Schneider), and Jamie Scott, Inc. (owned by his three children, Leslie, Susan and Scott Schneider). These two businesses were combined to form a division of McNaughton called Jeri-Jo Knitwear, Inc. (Jeri-Jo). Under the terms of the Agreement of Purchase and Sale, McNaughton paid the Schneiders $ 55 million in cash, assumed $ 10.9 million in debt, and agreed to a future earn-out payment based on Jeri-Jo's performance over the two-year period

ending in June 2000, during which the Schneider children managed this business for McNaughton.[1]

The earn-out payment was fixed at $ 190 million, which the Agreement called for McNaughton to pay to the Schneiders in cash or, at McNaughton's option, up to 50% in common stock. In light of available cash flow, however, McNaughton was only able to make the minimum cash payment, and wished to avoid the significant dilutive effect on earnings of paying the balance in stock. As an alternative, McNaughton proposed issuing the Schneiders a three-year note secured solely by the face value of the stock to which they were entitled. Ultimately, McNaughton and the Schneiders compromised, agreeing to retire the earn-out obligation as of August 29, 2000 for $ 161 million, consisting of $ 125 million in cash ($ 95 million to be paid immediately and $ 30 million to be paid on or before November 30, 2000, subject to financing); two million shares of common stock at $ 13 per share ($ 26 million); and four three-year subordinated promissory notes with a combined face value of $ 10 million. They also agreed that if financing could not be arranged for the $ 30 million cash payment, McNaughton would pay the Schneiders $ 59 million in a combination of cash,

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1. Earn-out provisions in merger-and-acquisition agreements are intended to accommodate the seller's desire for compensation for the anticipated future value of the transferred assets and the buyer's reciprocal desire to avoid overpaying for potential, but as yet unrealized, value. In this case, the earn-out was based on Jeri-Jo's profitability, not its sales.

unsecured subordinated notes and/or shares of common stock at McNaughton's option.

In October 2000, McNaughton's chief executive officer informed the Schneiders that, given McNaughton's stock price, the company was unlikely to raise the additional equity needed to fund the $ 30 million payment fast coming due. He asked the Schneiders to extend the November 30th deadline to April 30, 2001. In the end, the Schneiders declined this request and, on December 10, 2000, four three-year subordinated promissory notes with an overall face value of $ 59 million were issued to them in lieu of the $ 30 million cash payment.

The eight notes with an aggregate face value of $ 69 million (the four issued in August 2000 plus the four issued the following December), running 12 pages apiece, were each payable to one or another of the four Schneiders[2]. The notes required McNaughton to make quarterly principal and monthly interest payments to the named payee. McNaughton was designated the maker of the notes, each of which bore the following

2. Specifically, the subordinated promissory notes issued and dated August 29, 2000 were payable to Leonard Schneider in the amount of $ 4 million; Leslie Schneider in the amount of $ 2.4 million; Scott Schneider in the amount of $ 1.2 million; and Susan Schneider in the amount of $ 2.4 million. The subordinated promissory notes issued December 10, 2000 and dated December 1, 2000 were payable to Leonard Schneider in the amount of $ 23.6 million; Leslie Schneider in the amount of $ 14.16 million; Scott Schneider in the amount of $ 7.08 million; and Susan Schneider in the amount of $ 14.16 million.

restrictive legend: "THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. IT MAY NOT BE TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT OR AN OPINION OF COUNSEL TO THE MAKER THAT SUCH REGISTRATION IS NOT REQUIRED." Each note was marked "SUBORDINATED PROMISSORY NOTE" on its face because these notes were subordinate to McNaughton's existing bank and bond debt amounting to roughly $ 350 million. Upon McNaughton's default, the payee had the right to declare the entire amount under the note due and owing, and to elect either to receive payment in stock or to accelerate payment. The notes stated that they were "governed by and construed in accordance with" New York law.

The securities industry professionals who subsequently dealt with the notes considered them to be high-risk debt akin to junk bonds. Consequently, it was anticipated that any potential purchaser would expect a high yield or internal rate of return. Concomitantly, the notes carried a substantial, variable interest rate (initially, 9.34% on the December notes).

As it turned out, McNaughton was acquired in June 2001 by Jones Apparel Group, Inc. As a result of the merger (an "Event of Default" under the terms of the notes), Jones redeemed the notes at par value, paying the Schneiders $ 69 million plus interest through June 19, 2001. The parties to this litigation dispute whether the Schneiders reneged on an oral agreement to sell

seven of the eight notes when they learned of the planned acquisition before it was announced to the public. In particular, Highland Capital Management LP alleges that the Schneiders, through their agent and broker, Glen Rauch of Glen Rauch Securities, Inc., retained RBC Dominion Securities Corporation (now RBC Capital Markets Corporation) to market the notes on their behalf, and that on March 14, 2001, RBC purchased the notes from the Schneiders for 51 cents on the dollar, and then immediately resold seven of the eight notes to Highland for 52.5 cents on the dollar. [3]

On October 18, 2001, Highland brought this suit against the Schneiders in Texas state court. The action was removed to federal court in Texas on diversity grounds, and then transferred to the United States District Court for the Southern District of New York. As relevant here, the complaint alleges that the Schneiders breached an oral agreement to sell the notes to Highland or, alternatively, breached a binding preliminary agreement to do so, or breached an agreement to sell the notes to RBC, of which Highland was a third-party beneficiary[4]. The Schneiders

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3. Highland alleges that RBC resold the remaining note to Fidelity Management and Research Company, also on March 14, 2001 and for 52.5 cents on the dollar.

4. RBC intended to act as a "riskless principal." That is, RBC sought to eliminate its risk for variable market conditions by obtaining commitments to a specified price from both the seller (here, 51 cents on the dollar) and the ultimate buyer (here, 52.5 cents on the dollar from two buyers) before executing a trade with the seller. RBC's compensation on the transaction would have been the spread between these two prices.

answered, denying they had ever agreed to sell the notes to anyone on March 14, 2001 at any price, and asserting that any such oral agreement would have been unenforceable anyway since it fell within the statute of frauds. After the close of discovery, the Schneiders moved for summary judgment to dismiss the complaint.

The Uniform Commercial Code generally bars enforcement of purported agreements to sell personal property in excess of $ 5,000 unless "there is some writing which indicates that a contract for sale has been made between the parties at a defined or stated price, reasonably identifies the subject matter, and is signed by the party against whom enforcement is sought or by his authorized agent" (UCC 1-206 [1]). In considering the Schneiders' statute-of-frauds defense, the District Judge observed that the statute does not apply to a contract for the sale or purchase of a "security" (UCC 8-113) (*Highland Capital Mgmt. LP v Schneider*, 2005 US Dist LEXIS 14912, *42, 2005 WL 1765711, *13 [SD NY, July 26, 2005] citing *Wharf (Holdings) Ltd. v United Int'l Holdings, Inc.*, 532 US 588, 595, 121 S Ct 1776, 149 L Ed 2d 845 [2001] ["Oral contracts for the sale of securities are sufficiently common that the Uniform Commercial Code and statutes of frauds in every State now consider them enforceable"]). He concluded, however, that the seven promissory notes were not securities for purposes of article 8 of the Uniform Commercial Code, because they were not transferrable within the meaning of section 8-102 (a) (15) (i).

The District Judge dismissed Highland's two breach-of-contract claims against the Schneiders on the merits.

Although he found an issue of material fact with respect to Highland's claim to be a third-party beneficiary of a contract between the Schneiders and RBC, the District Judge dismissed this cause of action for lack of subject matter jurisdiction. He reasoned that since the underlying oral agreement, even if proven, would only be enforceable up to $ 5,000 because of the statute of frauds, the claim fell short of the $ 75,000 statutory threshold for diversity jurisdiction. Highland appealed.

"Given the dearth of caselaw on what constitutes a security under the New York version of [article 8] of the New York U.C.C., and the manifest significance of the determination," the Second Circuit retained jurisdiction over Highland's three contract-based claims, and certified the following question to us: "Based on this record, do the eight promissory notes issued by McNaughton Apparel Group, Inc., to the Schneiders fall within the definition of a security as contemplated by section 8-102 (a) (15) of the New York Uniform Commercial Code?" (*Highland Capital Mgmt. LP v Schneider*, 460 F3d 308, 322 [2d Cir 2006] [quotation marks omitted]). We answer that question in the affirmative.

II.

The Uniform Commercial Code defines "security" at section 8-102 (a) (15) as

> "an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

"(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;

"(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and

"(iii) which:

"(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or

"(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article."

Thus, the promissory notes must fulfill the requirements of subparagraphs (i) (the transferability test), (ii) (the divisibility test) and (iii) (the functional test) of section 8-102 (a) (15) in order to qualify as a security for purposes of article 8 (*see generally* UCC 8-102, Comment 15; 7A Hawkland and Rogers UCC Series § 8-102:01 [rev art 8]; *see also*, Report on Proposed Revisions to Article 8 to Assn of Bar of City of NY as prepared by Comms on Uniform State Laws and Banking

Appendix G

> Law, Bill Jacket, L 1997, ch 566, at 65 ["'Security' as defined in Revised Section 8-102 (a) (15) . . . includes . . . any other obligation of the issuer . . . that is transferable, divisible, and is dealt in or traded on securities exchanges"]).

First, we must consider whether the notes are obligations "represented by a security certificate in bearer or registered form." Section 8-102 (a) (4) defines a "[c]ertificated security" as "a security that is represented by a certificate," and section 8-102 (a) (16) defines a "security certificate" as "a certificate representing a security." These definitions are, as the Second Circuit observed, somewhat circular, and might refer either to a specialized document like a traditional stock certificate or, more generally, to a paper embodying the underlying intangible interest. Of course, the definitions in section 8-102 were deliberately worded by the drafters "in *general terms*, because they must be sufficiently *comprehensive and flexible* to cover the wide variety of investment products that now exist or may develop" (UCC 8-103, Comment 1 [emphasis added]). We see no reason to accept the Schneiders' invitation to read "certificated security" and "security certificate" more narrowly than their plain words suggest. Thus, we interpret these terms to encompass the eight subordinated promissory notes, which are papers that definitively embody and evidence the underlying intangible obligation of McNaughton to the Schneiders. The notes are obviously not in bearer form;

therefore, our next inquiry is whether they are in "registered form." In this regard, section 8-102 (a) (13) states that

> " '[r]egistered form,' as applied to a certificated security, means a form in which:
>
> "(i) the security certificate specifies a person entitled to the security; and
>
> "(ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states."

Each of the notes specifies one of the four Schneiders as the "person entitled to the security," which satisfies section 8-102 (a) (13) (i). Accordingly, we must next look at whether "a transfer of the security *may be* registered upon books maintained for that purpose by or on behalf of the issuer," as required by section 8-102 (a) (13) (ii) (emphasis added). The Schneiders (and the dissent) argue that in order to fulfill this requirement, McNaughton must have set up or kept separate and independent transfer books for this purpose at the time it issued the notes. We agree with the Second Circuit, however, "that the proper inquiry is whether the notes *could have been* registered on transfer books maintained by McNaughton, not whether they were registered on transfer books at the time of the litigation" (460 F3d at 314 [discussing identical language in section 8-102 (a) (15) (i)]).

In this regard, the rules in part 4 of article 8 are instructive. Part 4, along with parts 2 and 3, deals with the rights of persons who hold certificates directly, as the Schneiders did here. Section 8-401 sets out the preconditions that trigger the issuer's duty to register a certificated security when it is presented with a request to register a transfer.[5] Thus, the phrase "may be registered" in section 8-102 (a) (13) (ii) refers to whether McNaughton would have been required to register the transfer of the notes to a third-party at the Schneiders' request.

We conclude that McNaughton ultimately would have been constrained to do so. McNaughton did not restrict transfer of the notes other than by the legend, as its chief executive officer acknowledged. And the restrictive legend itself suggests that the parties contemplated the possibility of future transfer. As Highland points out, as a practical matter, McNaughton would have to have recorded any transfer of the notes

5. These preconditions for certificated securities include whether, under the security's terms, the person seeking registration of transfer is eligible to have the security registered in his name; the indorsement is made by the appropriate person or an agent with actual authority; reasonable assurance is given that the indorsement is genuine and authorized; applicable tax laws have been complied with; the transfer does not violate any restriction on transfer imposed by the issuer against a person with actual knowledge, or constructive knowledge (i.e., any restriction is conspicuously noted on the certificate); there is not in force an effective demand by a registered owner that the issuer not register a transfer; and the transfer is in fact rightful or is to a protected purchaser (*see* UCC 8-401).

in order to protect itself and the senior debt holders. For example, in the event of default, the payee of the notes could have elected conversion of the principal to common stock, thus diluting other shareholders' value; and because the notes called for hefty payments of principal and interest, McNaughton had to have a way to keep track of the proper payees. Accordingly, we conclude that the notes satisfy the transferability test in UCC 8-102 (a) (15) (i): they were obligations represented by a security certificate in registered form.[6]

Further, the notes satisfy the divisibility test in section 8-102 (a) (15) (ii). "[M]inimum compliance with this formality requires that there be at least two instruments in a specified class or series, or that the single instrument be divisible into at least one additional instrument" (*Allegaert Chemical Bank*, 657 F2d 495, 507 [2d Cir 1980] [citation and quotation marks omitted]; *see also Baker v Gotz*, 387 F Supp 1381, 1390 [D Del 1975] [where six notes are issued for a total of 25,360,000

6. We note that we are not "confusing registrability upon transfer books with recording in corporate books generally," as the dissent contends (dissenting op at 7). Rather, we conclude, for the reasons stated, that "the notes *could have been* registered on transfer books maintained by McNaughton" (460 F3d at 314 [emphasis in original]). The dissent also acknowledges that McNaughton had (or must have had) transfer books (presumably, to register transfer of the 121/2; senior notes), but asserts that "those books were not available for registering transfers of the notes at issue here" (dissenting op at 5). Even if correct, this pronouncement begs the question of whether, in light of *section 8-104*, McNaughton would have been required to register transfer of the subordinated promissory notes if the Schneiders had asked McNaughton to do so.

Swiss francs, the notes are "patently one of a class or series"] [citation and quotation marks omitted]; UCC 8-102, Comment 15 ["The divisibility test of subparagraph (ii) applies to the security — that is, the underlying intangible interest"]). Here, there were eight notes, divided into two groups of four notes each. The eight notes were identified in McNaughton's Form 8-K as a class of obligations, in the same category, in fact, as McNaughton's 121/2;% senior notes, which the Schneiders concede were article 8 securities.

Next, the notes fulfill the functional test in section 8-102 (a) (15) (iii) (A) because these obligations "[were], or [were] of the type, dealt in or traded on securities exchanges or securities markets." This component "provides flexibility while ensuring that the Article 8 rules do not apply to interests or obligations in circumstances so unconnected with the securities markets that parties are unlikely to have thought of the possibility that Article 8 might apply" (UCC 8-102, Comment 15). Tellingly, the many securities industry professionals from Rauch, RBC and Highland who dealt with the notes uniformly treated them as securities. McNaughton's chief executive officer, when he first proposed issuing the notes in lieu of cash or stock, described them as a "form of convertible subordinated debenture." When McNaughton issued the notes to the Schneiders in August 2000, it reported its actions to the Securities and Exchange Commission, and put out a press release to inform the public.

Finally, our determination that these subordinated promissory notes are article 8 securities is consistent with existing caselaw, sparse though it may be (*see e.g. Vigilant Ins. Co. of Am. v Hous. Auth. of El Paso*, 87 NY2d 36, 43, 660 NE2d 1121, 637 NYS2d 342 [1995] [stating broadly that "article 8 of the Uniform Commercial Code . . . governs stocks, bonds and other evidences of indebtedness"]; *see also Baker, supra* [promissory notes are securities under section 8-102]; *S.N. Phelps & Co. v Prudential Ins. Co. of America*, US Dist Ct, Conn, Nov. 22, 1991, Cabranes, J. [considering senior subordinate notes, essentially indistinguishable from the subordinated promissory notes in this case, to be article 8 securities]). Treating these notes as article 8 securities comports with a central goal of the Uniform Commercial Code, which is to create a framework for commercial activity that reflects and fosters developing custom and usage. Or as one commentator remarked with specific reference to article 8: "[T]he definition [of securities] will change as 'securities' trading practices evolve to include or exclude new property interests. It is believed that the definition will cover anything which securities markets, including not only the organized markets but as well the 'over-the-counter' markets, are likely to regard as suitable for trading" (8 Lawrence, Lawrence's Anderson on the Uniform Commercial Code § 8-102 :1, at 29 [3d ed rev 2005]; *see also Bentley v ASM Communications. Inc.*, 1991 US Dist LEXIS 7855, at *5-6, 1991 WL 105220, at *2 [SD NY, June 11, 1991] [citing pre-1997 Comment 2 to section 8-102 to support defining the term "security" broadly]).

Accordingly, the certified question should be answered in the affirmative.

DISSENT BY: SMITH, J.

DISSENT

The question of when a promissory note is a "security" is a familiar one in federal securities law, and has proved very difficult (*see e.g. Reves v Ernst & Young*, 494 US 56, 110 S Ct 945, 108 L Ed 2d 47 [1990]; *Chemical Bank v Arthur Andersen & Co.*, 726 F2d 930 [2d Cir 1984]; *Exchange Nat. Bank of Chicago v Touche Ross & Co.*, 544 F2d 1126 [2d Cir 1976]). The authors of the Uniform Commercial Code made the question of what is a "security" for UCC purposes easier, by including in the definition of "security" an element not present in federal securities law: with some exceptions, an obligation is not a security for UCC purposes unless it "may be registered upon books maintained for that purpose by or on behalf of the issuer." Today, the majority effectively undoes the work of the UCC's authors, by reading this registrability requirement in so broad a way as to make it meaningless.

Though it is not apparent from the majority opinion, registrability is the only significant issue in this case. No one disputes that what the majority calls the "divisibility test" and the "functional test" in the UCC definition of "security" (UCC 8-102 [a] [15] [ii], [iii]) are met here. The majority holds that the notes at issue are "represented by securities certificates" within the

meaning of UCC 8-102 (a) (15) (i), but it does not matter whether the majority is right or wrong about this, because registrability is necessary to make either an uncertificated obligation or a non-bearer certificated obligation into a security. If the obligation is certificated, the certificate must be in either "bearer or registered form," and the definition of "registered form" requires that "a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states" (UCC 8-102 [a] [13] [ii]). If the obligation is not certificated, it is still a security if it meets the other tests and its "transfer . . .. may be registered upon books maintained for that purpose by or on behalf of the issuer" (UCC 8-102 [a] [15] [i]). Registrability is therefore critical, whether there is a certificate or not.

Before considering the meaning of the registrability requirement, it is useful to consider why the UCC's authors made it part of their definition of "security" — a definition that is completely independent of the federal securities law definition of the same term (*see* UCC 8-102, Comment 3 [1977 Amendments] reprinted in, 8 Lawrence's Anderson on the UCC § 8:102:1, at 29-30 [3d ed rev 2001]). The apparent reason for the requirement is to facilitate line-drawing — to provide a relatively simple test to distinguish between obligations and interests that are securities and those that are not. As the Official Comment says: "The definition of registered form .. . . . [s]erves primarily to distinguish Article 8 from instruments governed by other law, such as Article 3" (UCC 8-102, Comment 13).

These distinctions matter. For example, the rights and obligations of an issuer and holder of an Article 3 negotiable instrument are substantially different from those of an issuer and holder of an Article 8 security. The issuer of a security in registered form may treat the registered owner as the owner for all purposes, until the security is presented for registration of transfer (*see* UCC 8-207 [a]). The issuer of an unregistered negotiable instrument does not have that option. The indorser of a negotiable instrument may also be liable to subsequent holders in the event that the issuer defaults (*see* UCC 3-413). The indorser of an article 8 security, in contrast, makes no warranties with respect to the issuer's ability to satisfy the underlying obligation (*see* UCC 8-108).

The need for clear distinctions led the authors of the UCC to adopt the formalistic requirement of registrability. Such formalism would be out of place in the federal securities laws, which have the prevention of fraud and other abuses in securities markets among their primary purposes. Congress wanted to make evasion of the federal securities laws difficult, and accordingly:

> "[i]n defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits,' *SEC v W. J. Howey Co.*, 328 US 293,

> 299, 66 S Ct 1100, 1103, 90 L Ed 1244 (1946), and determined that the best way to achieve its goal of protecting investors was 'to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" [*United Housing Foundation, Inc. v Forman*, 421 US 837, 847-848, 95 S Ct 2051, 44 L Ed 2d 621 (1975)](quoting H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment"

(*Reves*, 494 US at 60-61).

The UCC is less concerned with frustrating the ingenuity of schemers, and more with providing a workable and predictable code to govern legitimate transactions. The purposes of the UCC are therefore well served by making the line between securities and other interests and obligations as clear as possible — a clarity that is lacking in federal securities law. The "broad brush" approach of the federal securities laws prompts participants in transactions to err on the side of caution, and to assume — as the parties in this case did — that anything near the borderline is a "security"

for federal purposes. But the goal of the UCC is to mark the border plainly. Registrability is a test well suited to that goal. It has long been a common practice for issuers of stocks, bonds, notes and other obligations or interests to maintain (or to retain a transfer agent to maintain) books on which the transfers of these obligations and interests may be registered. It is not hard to determine whether such books exist or not. If they do, then "transfer [of the obligation or interest] may be registered upon books maintained for that purpose by or on behalf of the issuer" and the registrability requirement is met.

In this case, no claim is made that McNaughton, the issuer of the notes in suit, maintained (itself or through an agent) transfer books on which transfers of these notes could be registered. McNaughton did have transfer books, and transfers were registered on them — including transfers of certain classes of promissory notes — but those books were not available for registering transfers of the notes at issue here. That should end the inquiry: the registrability requirement is not met, and these notes are not securities.

The majority's contrary conclusion rests in part on circular reasoning. It finds that these notes "may be" registered because UCC 8-401 would require registration — but that section applies only to "a certificated security in registered form." Whether the notes are such securities is the very question the majority is deciding.

Appendix G

The majority also seeks to justify its result by over-emphasizing some words in the statutes describing the registrability requirement and ignoring others. It emphasizes the words "may be" (majority op at 10), which the majority seemingly takes to mean that the notes are registrable if any books could possibly exist in which transfers of the notes could be registered. Read so broadly, the words "may be" deprive the registrability requirement of any meaning — it is always theoretically possible there could be books on which transfers of anything could be registered. The words "may be registered upon books maintained for that purpose" are much more plausibly read to mean that "books maintained for that purpose" must exist, on which transfers may (or may not) be registered. In other words, the requirement is met whether transfers are actually registered on the books or not, but not if there are no books "maintained for that purpose" on which registration could occur.

The majority ignores the statutory words "maintained for that purpose." It concludes that the registrability requirement is met because, if the notes are transferred and McNaughton is informed of the transfer, it must obviously record the information somewhere, so that it will have "a way to keep track of the proper payees" (majority op at 12). On this reading of the statute, it is hard to imagine any transferable obligation of any issuer that would not be registrable. The right question is not whether transfers may be reflected in some way in McNaughton's books and records — of course they may — but whether they "may be registered *upon books maintained for that purpose.*"

Appendix G

Confusing registrability upon transfer books with recording in corporate books generally was essentially the error criticized, in another context, by a distinguished panel of the Second Circuit Court of Appeals in *Gerard v Helvering* (120 F2d 235 [2d Cir 1941] [per curiam; L. Hand, Chase and Frank, JJ.]). The issue there was whether payments on a certain bond were a "retirement" of "capital assets" for federal income tax purposes, a question that in turn depended on the registrability of the bond. The court said:

> "[the taxpayer] cannot succeed unless [the bond] was 'in registered form,' a phrase whose meaning in this context is entirely plain. It refers to the common practice in the issuance of corporate bonds which allows the holder of one or more coupon bonds of a series the option to surrender them and have one bond 'registered' upon the books of the obligor or of a transfer agent; or the holder may subscribe for such a bond in the first place. The purpose is to protect the holder by making invalid unregistered transfers, and the bond always so provides upon its face. *The mere fact that the debtor keeps books of account upon which the debt appears is altogether immaterial*; to construe the statute as the taxpayer asks would in effect make the payment of any corporate debt - evidence of indebtedness' - a 'retirement' of 'capital assets,' for almost all corporations keep books. It is scarcely necessary to labor

the answer to so plain a misinterpretation" (120 F2d at 235-236 [emphasis added]).

I find the majority's error in interpreting the UCC here to be equally plain.

Chief Judge Kaye and Judges Ciparick, Graffeo and Jones concur. Judge Smith dissents and votes to answer the certified question in the negative in an opinion in which Judge Pigott concurs.

Following certification of a question by the United States Court of Appeals for the Second Circuit and acceptance of the question by this Court pursuant to section 500.27 of the Rules of Practice of the New York State Court of Appeals, and after hearing argument by counsel for the parties and consideration of the briefs and the record submitted, certified question answered in the affirmative.